No. 82-868

Office - Supreme Court, U.S.
FILED
NOV 22 1982
ALEXANDER L. STEVAS,
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

RECORD WIDE DISTRIBUTORS, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

CLAUDE HANKS, ESQ.
MB #16030
725 Old Ballas
Foreway Building
Creve Coeur, Missouri 63141
Tele: (314) 432-1170
Attorney for Petitioner

Of Counsel for Petitioner
LEONARD R. YOCUM, ESQ.
MB #15444
725 Old Ballas
Foreway Building
Creve Coeur, Missouri 63141
Tele: (314) 567-1424

St. Louis Law Printing Co., Inc., 411 No. Tenth Street 63101 314-231-4477

To The Honorable, The Chief Justice And Associate Justices Of The Supreme Court Of The United States:

Record Wide Distributors, Inc., the petitioner herein, prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Eighth Circuit entered in the above entitled case on July 14, 1982

QUESTIONS PRESENTED

1. Taxpayer, for the years in question, used a cash method of accounting which was also referred to as a hybrid method of accounting. The revenue agent changed taxpayer from cash to the accrual method of accounting. The question presented is whether the revenue agent can change the taxpayer's method of accounting without first finding that taxpayer's method did not clearly reflect income as required by IRC Section 446 (b);

2. Must a taxpayer using inventories as a part of its accounting method be mandated to use a strict accrual method of accounting even though IRC Section 446 (a); Reg. 1-446-(a) (1) allows the taxpayer to compute its taxable income on the basis of which the taxpayer regularly computes its income?

3. Does a revenue agent who has no proven qualifications in accounting background or expertise possess the broad discretionary power of the "Commissioner" in making decisions relative to what accounting methods do or do not clearly reflect the income of the taxpayer.

4. Should this Court recognize that a deduction for a bad debts reserve in the year 1974 should be allowed to Petitioner who has been changed from cash to the accrual method of accounting by an audit in 1976? Should not the right to use and take advantage of such a bad debt deduction be allowed to Petitioner as is allowed all other accrual basis taxpayers?

TABLE OF CONTENTS

	Page
Questions Presented	i
Table of Contents	iii
Table of Cases and Authorities	iv
Opinion Below	1
Jurisdiction	1
Statutes and Regulations Involved	2
Statement of the Case	2
Reasons for Granting Writ	6
Appendix:	
Appendix A - Opinion of The United States Court of Appeals No. 81-1853 for the Eighth Circuit filed July 14, 1982	A-1
Appendix B - Order of Court of Appeals Denying Petition for Rehearing on August 24, 1982	A-8
Appendix C - Opinion of The Tax Court of the United States No. 11595-78 filed January 12, 1981	A-9
Appendix D - Decision of The Tax Court entered January 12, 1981	A-20
Appendix E - Modified Decision of The Tax Court entered April 10, 1981	A-21
Appendix F - Excerpts from Transcript of Testimony in The Tax Court	A-22

Table of Cases and Authorities

Bradstreet Co. of Maine v. Commissioner, 65 F.2d 943, 945 13,16

Calavo, Inc. v. Commissioner, 304 F.2d 650, 651-52, 654 n 4, 655 (CA 9 1962) 17,18

Caldwell v. Commissioner, (2d Cir. 1953), 202 F.2d 112, 116 17

Clark V. Commissioner, 85 F.2d 622 16

Ezo Products Co., 37 T.C. 385, 393 (1961) 6,11

Glenn v. Kentucky Color and Chemical Co., Inc., 1949, D.C. Ky. 87 F.Supp. 618, aff'd (CA 6) 186 F.2d 975 11

Griffin v. Commissioner, 285 F.2d 91 11

Harry Hartley, 23 T.C. 353, 358 (1954) 7

Huntington Securities Corporation v. Busey, (6 Cir. 1940), 112 F.2d 368, 25 AFTR 82 rev'g (DC Ohio), 26 F.Supp. 849, 22 AFTR 802 10,11,13

Michael Drazen, supra, at 1079 6

Neiderkrome v. Commissioner, 266 F.2d 238 11

Estate of Howard T. Roe, 36 T.C. 939, 952 (1961) 6

Stanford R. Brookshire, 31 T.C. 1157, 1166 (1959), aff'd. 273 F.2d 638 (4th Cir.), cert. denied, 363 U.S. 827, 80 S.Ct. 1597, 4 L.Ed.2d 1523 (1960) 6

Theodore H. Beckman, 8 B.T.A. 830, 831 (1927) 6

Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 58 L.Ed.2d 785, 99 S.Ct. 773 17,18

Victor and Evelyn Blanco, 56 T.C. 512, T.C. Memo 1973-247 11

Wilknison - Beane, Inc. v. CIR, 420 F.2d 352, footnote 9 6

Statutes and Regulations

IRC Section 446 and subsections (a) (b) (c) 2,7,10

IRC Section 166, subsection (c) 2

Reg. 1-446-1 and subsections (a), (b), and (c) 2,8,9,10,14

Reg. 39-41-1 (1939) 2,14

Reg. 39-41-2 (1939) 2,14

Miscellaneous

T. C. Rule 143 (b) 11

2 J. Mertens, Law of Federal Income Taxation Sec. 16.03, at 6 (Malone rev. ed. 1967) 7

Black's Law Dictionary, Revised Fourth Edition, 1968 . 13

No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

RECORD WIDE DISTRIBUTORS, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

OPINIONS BELOW

The Opinion of the United States Court of Appeals for the Eighth Circuit, and whose judgment is sought to be reviewed, is reported at 682 F2d 204 and is reprinted in the separate Appendix A hereto, pages A-1-A-7. The prior opinion of the Tax Court of the United States is reprinted in Appendix C hereto, pages A-9-A-19 and is reported at TC Memo 1981-12.

JURISDICTION

The judgment of the United States Court of Appeals for the Eighth Circuit (Appendix A pages A-1-A-7) was entered on July 14, 1982. A timely petition for rehearing was denied on August 24, 1982. (Appendix B hereto, page A-8). The jurisdiction of the Supreme Court is invoked under 28 USC 1254 (1).

STATUTES AND REGULATIONS INVOLVED

IRC Section 446 and subsection (a) (b) and (c)

IRC Section 166, subsection (c)

Reg. 1-446-1 and subsections (a), (b), and (c)

Reg. 39-41-1 (1939)

Reg. 39-41-2 (1939)

The above Statutes and Regulations are set out in the Reasons for Granting Writ.

STATEMENT OF THE CASE

This is a case for the determination of deficiencies for Petitioner's income taxes for the years 1972, 1973 and 1974. The Tax Court determined those deficiencies in the amounts of $53,947.55, $47,985.17 and $31,203.54 respectively after finding that the Commissioner properly changed Petitioner from the cash to the accrual method of accounting. Petitioner had been placed on the accrual method of accounting after consistently using a cash method for the three years in question. The authority for the Commissioner to do this under his regulatory power has been challenged by the taxpayer for the reason that its method clearly reflected income and was, therefore, not subject to being validly changed by the Commissioner. The Commissioner's evidence contained no reference to the taxpayer's method as not clearly reflecting income. The Commissioner's position is that the use of inventories by the taxpayer mandated the accrual method, therefore, the Commissioner changed taxpayer's method from cash to accrual. The Tax Court upheld the Commissioner, as did the Eighth Circuit Court of Appeals.

There are secondary issues involving the proper or improper accrual of accounts receivable and the disallowance by the Commissioner of a bad debt deduction of a substantial amount.

Petitioner is a Missouri corporation, incorporated on March 7, 1972. Prior to that, the business was operated as a sole proprietorship known as "Bootheel Records." The corporate income tax returns for calendar years 1972, 1973, and 1974 were filed with the IRS Service Center at Kansas City, Missouri. The returns were prepared by Dennis G. Scharf for 1972, and Keith Robley, a C.P.A., for 1973 and 1974. The returns were prepared on the cash method of accounting.

Petitioner's corporate name is Record Wide Distributors, Inc. Petitioner is a wholesaler of phonograph albums, 8-track stereo tapes and cassettes. Among the products that they handle are cut-outs. Cut-outs are merchandise that the manufacturer cannot sell in its market place. Therefore, the manufacturer has to do something to get rid of these products, and they sell off these products (called loads) at some price to the highest bidder, or on a negotiated basis. Petitioner buys these cut-outs which have limited value and then puts a price on them that it thinks the product will bring in its distribution channels. Ninety to ninety-five per cent or more of Petitioner's business is in this cut-out merchandise. When Petitioner buys a "load" from a manufacturer, it receives, perhaps, one good title and four or five bad titles. Petitioner must buy the whole load and cannot pick and choose titles.

Petitioner ships these products (records and tapes) to various retail outlets throughout the country. The titles are selected by Petitioner and sent out to customers with a guarantee that any products not sold by the customer can be returned for full credit. The customer does not have to pay for the records until they sell them. Until all the records are sold (or the unsold records returned) there are no monies coming to Petitioner. As an example, if 50,000 records were shipped, no money would be due Petitioner until they were sold and until the customer returned what was not sold and then the customer would pay the difference. There are no written agreements with customers.

The return privilege is open-ended. It can go on for years. Petitioner acknowledged that this was a risky way to do business, but their business has increased throughout the years.

When Petitioner ships merchandise to the retailers, it also sends invoices to the customers. These are for the convenience of the customer. However, Petitioner has no way of knowing what his true accounts receivable are. The receivables mean nothing. Petitioner cannot depend on any definite amount of money from them at any definite time.

Petitioner's Vice-President estimated that its returns for merchandise shipped each of the years 1972, 1973, and 1974 were between 50 and 60 per cent, perhaps higher, as such returns were applied to purported receivables at the end of those years. Petitioner made this estimate based upon his examination of the 1978 returns in the year 1979. Also, he based his estimate for 1972, 1973, and 1974 on his experience in managing the company in those years.

Mr. Keith Robley, a certified public accountant and accountant for Petitioner, had audited businesses and prepared tax returns since 1956. He prepared the 1973 and 1974 returns of Petitioner and examined the 1972 return. He gave his opinion that the manner in which Petitioner's income was reported accurately portrayed Petitioner's income.

The facts relating to a secondary issue in the case are that one of the large retail customers of Petitioner, Sound On, owed Petitioner in excess of $176,000 at the end of the calendar year 1974. Due to Sound On's precarious financial position in 1974, Petitioner had placed Sound On on a C. O. D. basis for credit purchases for the reason of nonpayment of Sound On's past due balance. Because it filed its returns on a cash basis, there was no reason for Petitioner to use a deduction for bad debts on its 1974 return because Petitioner had never accrued and reported the sales to Sound On as income. Consequently, when

the revenue agent changed taxpayer's accounting method from cash to accrual in 1978 for the year 1974, she did not allow for any bad debt deduction for the debt of Sound On.

Rose Marie Stuckey, and IRS agent, was assigned to audit the 1972 returns of Petitioner. She also audited the 1973 and 1974 returns after potential adjustments to the 1972 returns. On her audit, she changed the method of accounting of Petitioner from cash to the accrual method. She increased the gross sales for each year by the increase in accounts receivable and made an appropriate increase or decrease to gross sales, based upon the increase or decrease in accounts payable. She did this because Petitioner maintained an inventory and derived its gross income from the sale of tapes and records and, therefore, she stated, the regulations required that Petitioner use the accrual method of accounting. The amounts of the increases were stipulated to be $207,775.41 in 1972; $55,759.47 in 1973; and $44,233.93 in 1974. However, she refused and the Tax Court upheld the disallowance of any bad debt deduction for Sound On for the year 1974.

Jurisdiction of the Tax Court arose after the taxpayer received notice of deficiencies for the years 1972, 1973, and 1974 by letter from the Regional Commissioner dated July 11, 1978. Taxpayer then filed its Petition in the Tax Court within ninety (90) days after receipt of such notice. After the decision of the Tax Court was rendered on April 10, 1981, Petitioner filed its motions to vacate or revise its decision and for reconsideration of its findings and opinion. These motions were denied on May 14, 1981 and Notice of Appeal to the Eighth Circuit Court of Appeals was filed on August 10, 1981, within ninety (90) days of the denial of Petitioner's motions. Jurisdiction of the review of the decision of the Tax Court in this case arises under the provisions of Section 7482 (a) of the Internal Revenue Code.

REASONS FOR GRANTING THE WRIT

I

Certiorari Should Be Granted For The Reason That The Eighth Circuit Court Of Appeals Has Decided A Question Of Federal Law Involving The Use Of Inventories Which Has Not Been, But Should Be, Settled By This Court. In Addition, There Appear To Be Conflicts Between The Eighth Circuit And Other Circuits On This Question.

The Court of Appeals held that the use of inventories by the Taxpayer "clearly mandate the use of an accrual accounting method," (Opinion p. 3 App. A-5) and, therefore, the Commissioner did not abuse his discretion by changing the accounting method of the Taxpayer from cash to accrual. Of all the decisions relating to the authority of the Commissioner to change a taxpayer's accounting method, none have been so sweeping as to hold that the use of inventories, alone, mandate an accrual method of accounting for reporting income. We do not believe that, as an abstract statement of law, the use of inventories mandate the taxpayer to use a strict accrual method of accounting. This court has not decided such issue even though the various circuits have skirted the question by relying on various fact situations to arrive at their conclusions. Therefore, we think it imperative that this court declare itself on this important question. The First Circuit has acknowledged that the Tax Court, in a variety of contexts, has recognized that the presence of inventories does not necessarily mean that the cash basis does not clearly reflect income. *Wilknison - Beane, Inc.* v. *CIR,* (C.A. 1) 420 F.2d 352, footnote 9, under which the following cases and authorities were cited: *Ezo Products Co.*, 37 T.C. 385, 393 (1961); *Estate of Howard T. Roe,* 36 T.C. 939, 952 (1961); *Michael Drazen, supra,* at 1079; *Stanford R. Brookshire,* 31 T.C. 1157, 1166 (1959), aff'd, 273 F.2d 638 (4th Cir.), cert. denied, 363 U.S. 827, 80 S.Ct. 1597, 4 L.Ed.2d 1523 (1960); *Theodore H. Beckman,* 8 B.T.A. 830, 831 (1927); *2 J.*

Mertens, Law of Federal Income Taxation Sec. 16.03, at 6 (Malone rev. ed. 1967); *contra Harry Hartley*, 23 T.C. 353, 358 (1954).

This case is centered upon IRC Section 446 and the regulations thereunder. IRC Section 446 reads as follows:

> (a) **General rule.** Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.
>
> (b) **Exceptions.** If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.
>
> (c) **Permissible methods.** Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—
>
> > (1) the cash receipts and disbursements method;
> >
> > (2) an accrual method;
> >
> > (3) any other method permitted by this chapter; or
> >
> > (4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.
>
> (d) **Taxpayer engaged in more than one business.** A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade of business.
>
> (e) **Requirement respecting change of accounting method.** Except as otherwise expressly provided in this chapter, a

taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate. (Aug. 16, 1954, Ch. 736, Stat. 151.)

Excerpts from pertinent subsectons of Reg. 1-446-1 are as follows:

(a) General rule.

(1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items.

* * *

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflect-

ing income, provided all items of gross income and expenses are treated consistently from year to year.

* * *

(b) **Exceptions.** (1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

(c) **Permissible methods—(1) In general.** Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

* * *

(2) **Special rules.** (i) In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph.

The three basic subsections of the regulation that we are concerned with are (a), (b) and (c). We shall take them in order and comment on the reported decisions as they affect our fact situation.

(a) General Rule

Petitioner used the cash method of accounting in reporting its income although the tax court termed it a hybrid method. The parties stipulated that such was the method used. This method was used by the sole proprietor predecessor of Petitioner. Subsection (1) recites that Petitioner can use the cash disbursement method or a combination of cash and accrual. Subsection (2) recites that it is recognized that no uniform method can be prescribed for all taxpayers. It also recites that the taxpayer can

adopt such forms and systems as are, in his judgment, best suited to his needs. It also recites that no method is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. With these allowances in mind, Petitioner's evidence showed:

1. Petitioner and its predecessor used the cash method for several years. (TR 88 App. A-25)

2. It was best suited to its needs. (TR 111-112-113 App. A-35-A-37)

3. It clearly (accurately) reflected its income. (TR 88-92 App. A-25-A-29; 101-113 App. A-29-A-37)

Petitioner was entitled to select a method of accounting on the basis of which it regularly computed its income in keeping its books. IRC Sec. 446(a); Regs 1-446-1(a). Petitioner was incorporated on March 7, 1972. It used the cash method of accounting for the calendar (taxable) years 1972, 1973, and 1974. This method selected was not changed by Petitioner for those years. The selection of the accounting system was lodged exclusively in Petitioner as long as it was within the statutory limits. *Huntington Securities Corporation* v. *Busey* (6 Cir. 1940), 112 F.2d 368, 25 AFTR 82 rev'g (DC Ohio), 26 F.Supp. 849, 22 AFTR 802.

The Commissioner's agent and auditor, Rose Marie Stuckey, stated that "The regulations require that whenever a taxpayer uses an inventory to compute their gross profit, they must use the accrual method of accounting." (TR 183-184 App. A-42-A-44)

There was no evidence from the Commissioner that Petitioner's accounting method did not clearly reflect income. The Commissioner (Rose Stuckey, the agent auditing the returns) rested on her finding that Petitioner used inventories in its accounting method and was, therefore, required to use the accrual method.

(b) Exceptions

This is the only provision in the code and regulations in which the Commissioner has the authority to change the accounting method of a taxpayer, and that authority does not arise until the Commissioner has made a finding that the Petitioner's method did not clearly reflect income. In construing tax statutes, the familiar rule prevails that the natural and ordinary meaning of the words used will be applied unless the Congress has definitely indicated an intention they should be otherwise construed. *Huntington, supra,* at 370. The Commissioner's authority to order a change in Petitioner's accounting method, when Petitioner regularly employed consistent methods, depends upon the Commissioner's finding that Petitioner's method did not clearly reflect income. *Glenn* v. *Kentucky Color and Chemical Co., Inc.,* 1949, D.C. Ky. 87 F. Supp. 618, aff'd (CA 6) 186 F.2d 975; *Ezo Products* v. *Commissioner, supra.*

The Commissioner may contend that the statement in the notice of deficiency constitutes such a finding. However, such notice was never admitted into evidence, and even if it were offered, it would not be admitted because agents' reports are hearsay. *Victor and Evelyn Blanco,* 56 T.C. 512; T.C. Memo 1973-247, T.C. Rule 143(b). Even if it was admissible, and such finding was presumed to be correct, the Commissioner must be held to the rule that once a taxpayer introduces competent and credible evidence tending to prove the deficiency was wrong, such presumption of correctness disappears and the presumption of correctness is overcome. *Griffin* v. *Commissioner,* 285 F.2d 91. The presumption of correctness disappears once evidence which would support a contrary finding is introduced. *Neiderkrome* v. *Commissioner,* 266 F.2d 238. The Petitioner's evidence that its accounting method conformed to its own unique method of doing business and the statement by two witnesses (TR 88-92 App. A-25-A-29) that it clearly reflected income would support a contrary finding to that of the Commissioner.

The arbitrary decision of Rose Stuckey to change the accounting method was not based upon any other reason than the fact that Petitioner used inventories. She made no finding that Petitioner's method did not clearly reflect income. She knew the policy on credits (returns) of Petitioner and that they appeared very large. She knew that Petitioner had a liberal return policy and that they had a lot of merchandise returned. She had eighteen months to gather her information, and she had complete cooperation from Petitioner (TR 196-199 App. A-44-A-47). Yet, she presented nothing to the Court to substantiate her finding except the bare statement that the regulations required her to make the change. The least she could have done would have been to analyze the information at hand and present, by a competent witness, a method of accounting that was capable of being observed and critiqued by the Court. The trial in the tax court revealed nothing about the qualifications of Rose Stuckey as an accountant or as having had accounting training. Her only qualification was that she had been a revenue agent for 7 years at the time of trial in 1979. That meant that when she started her audit in 1974, she had only 2 years experience, and when she finished the audit in 1976, she had only 4 years experience as a revenue agent. Compare this with the testimony of the attorney Mr. Wolbrink, (TR 85-86 App. A-23-A-24) with substantial tax experience, and that of Mr. Robley, a certified public accountant (TR 102-103 App. A-30-A-32) with 23 years experience. Why should any presumption in favor of the Commissioner prevail under those circumstances?

Mr. Robley testified that the so-called receivables that the Commissioner accrued (and which resulted in the deficiencies) would grossly distort income (TR 107-113 App. A-32-A-37). These "receivables" were only a list of customers which may have owed some money to Petitioner. Mr. Robley testified that they were not true accounts receivable (TR 107 App. A-32). We submit that the Commissioner did not sustain her burden of proof that her own method clearly reflected the income of Peti-

tioner. The burden to adopt a method that will clearly reflect the income is on the Commissioner equally as well as on the Petitioner. *Bradstreet Co. of Maine* v. *Commissioner,* 65 F.2d 943, 945.

(c) Permissive methods

We submit, first of all, by relying on the clear meaning of words, that this subsection is not applicable at all to any fact circumstances in this case. The subsection begins with the phrase, "subject to the provisions of subsections (a) and (b), a taxpayer may compute his taxable income under any of the following methods of accounting:". This subsection, then, is actually subordinate to subsections (a) and (b) which allow Petitioner to select its own method of accounting unless such method does not clearly reflect income. The Commissioner's position and argument, both in the tax court and the court of appeals, is that this subsection is paramount to (a) and (b), and that (a) and (b) are subordinate to this subsection. Under any interpretation of grammatical construction, the Commissioner's position is untenable. See *Blacks' Law Dictionary, Revised Fourth Edition,* 1968, in which "Subject To" is defined as:

> "Liable, subordinate, subservient, inferior, obedient to; governed or affected by;"

In construing tax statutes, the familiar rule prevails that the natural and ordinary meaning of the words used will be applied unless the Congress has definitely indicated an intention they should be otherwise construed. *Huntington* v. *Commissioner, supra.*

It is in this subsection (2) that the regulation states that in any case in which it is necessary to use an inventory, the accrual method must be used. However, this requirement is subordinate to subections (a) and (b). Therefore, if a cash or hybrid (combination of cash and accrual) method was regularly used by Petitioner and such method clearly reflected income, the re-

quirement of this subsection is not controlling because of the subordinate position such requirement must take to the allowances of (a) and (b).

We do know what prompted the Congress into making two similar provisions for acceptable accounting methods. It is clear that both (a) and (c) authorize the cash method or a hybrid of cash and accrual. We suggest to this Court that the permissive provisions of (c) are an outgrowth of the 1939 Regulation 39-41-2 entitled "Bases of computation and changes in accounting methods." We suggest that the Congress intended that the "permissive" methods in the 1939 Regulation related to a request for a change *by a taxpayer* to a different accounting method. In support of this theory, Reg. 39-41-1 entitled "Computation of net income." under the 1939 Code embodied the provisions of (a) and (b) of the 1954 Code regulations with which we are here concerned.

To summarize, Section 1-446-1-(a) and (b) allows Petitioner to select its own method of accounting within the statutory and regulatory limits of those subsections, and the Commissioner could not change the method of accounting from cash (hybrid) to accrual without first finding that Petitioner's method did not clearly reflect income. The Commissioner did not make such a finding; therefore, the decision of the Court of Appeals upholding the Tax Court in that regard is erroneous. Secondly, the provisions of Section 1-446-(c) have no application to the facts in this case, and the provision under subparagraph (2) of that subsection requiring an accrual method of accounting if inventories are used is subordinate to the allowed methods of subsection (a). These issues have not been settled by this Court and involves important questions of federal law that should be settled. In addition there appears to be a conflict between the First and Eighth Circuits on whether the use of inventories mandate a strict accrual method of accounting.

II

In The Alternative, Certiorari Should Be Granted For The Reason That The Eighth Circuit Court Of Appeals Has Decided A Question Of Federal Law Concerning A Deduction For Bad Debts That Conflicts With Opinions From The Second And Ninth Circuit Courts Of Appeals.

Petitioner had a major customer named Sound-On Tape Distributors, Inc. In 1974, Sound-On was indebted to Petitioner in excess of $176,000.00. Also, in February 1974, Sound-On was enjoined from selling certain "bootleg, duplicates, or counterfeit tapes." As a result, Sound-On's inventory was nearly worthless, and it returned the tapes to Petitioner. After crediting Sound-On for these returns, Sound-On owed Petitioner $176,574.22. (T.C. Opinion 4-5 - App. A-10-A-14). Sound-On had no monies to pay Petitioner after the middle of 1974. The only assets were racks and the inventory. The opinion of Mr. Holtzmann, of Sound-On, who ran the business, was that the business had failed and would not turn around. This was in the latter part of 1974. (Tr. 148-151 - App. A-39-A-42). Their purchases from Petitioner were charged to C.O.D. starting in 1974. (Tr. 48 - App. A-22). Mr. Robley, a C.P.A. for Petitioner, testified that the biggest part of Sound-On's obligation could not have been paid if the company liquidated. It was at least $107,000.00. (Tr. 134-135 App. A-37-A-38). The Commissioner's position is that the debt of Sound-On did not become worthless until 1978, at which time Sound-On ceased doing business and at which time Petitioner settled its account with Sound-On for $5,000.00

IRC Section 166, in part, covers the bad debt deductions we are concerned with in this part of our argument. Subsection (c) reads as follows:

> (c) Reserve for bad debts. In lieu of any deductions under subsection (a), there shall be allowed (in the discretion of

the Secretary) a deduction for a reasonable addition to a reserve for bad debts.

It is obvious that a substantial financial setback occurred to Sound-On in 1974. The major part of their business was destroyed by the injunction against the sale of bootleg tapes. It is the position of the Commissioner that none of the debt of Sound-On was worthless or even to be considered under a reserve for bad debts as far as the 1974 return is concerned because the statutory notice contains no deduction for it and the Commissioner does not now concede that Petitioner is entitled to a deduction in this regard. If a taxpayer's evidence would satisfy a reasonable man that the debt can only be recovered in part, the Treasury may not disallow the deduction. *Clark* v. *Commissioner,* 85 F.2d 622. By ignoring the Sound-On bad debt issue, the Commissioner has acted arbitrarily and unfairly toward Petitioner on this issue and by so doing has erred by adopting a method that does not clearly reflect the income of Petitioner. The burden to adopt a method that will clearly reflect the income is on the Commissioner equally as well as on the Petitioner. *Bradstreet Co. of Maine* v. *Commissioner, supra.* It should be remembered that Petitioner was on the cash basis and that there was no need to consider the bad debt issue for tax purposes when the return was filed for 1974. Petitioner received the statutory notice of deficiency shortly after it was mailed on July 11, 1978 (par. 3 of Petition and admitted by par. 3 of Answer). This notice came almost three years subsequent to the time the return was filed in September of 1975. Had Petitioner known that it was going to be put on a method that would require an accrual of accounts receivable, it could have made the decisiion then to consider the bad debt issue regarding Sound-On.

So long as Petitioner reported its income on the cash receipts method, there was, of course, no need for an allowance for the bad debt of Sound-On since sales were reported only as pay-

ment for them was received. But under the accrual method some such allowance or reserve is standard accounting practice, and is, indeed, necessary to approximate as nearly as possible the actual income for the year's sales. Therefore, even though the taxpayer never made any estimate of the uncollectible accounts receivable on its books, it should be permitted to deduct a reasonable allowance for the bad debts stemming from its 1974 Sound-On debt balance. *Caldwell* v. *Commissioner,* (2d Cir. 1953), 202 F.2d 112, 116. The *Caldwell* case seems to be almost exactly in point on this issue. The Commissioner changed the taxpayer from cash to accrual. However, the Second Circuit required the Commissioner to allow a reasonable allowance for the bad debts stemming from taxpayer's credit sales.

The opinion of the Eighth Circuit on this point is in conflict with that of the Second Circuit. The Commissioner's action in not allowing any deduction for the bad debt of Sound-On is not only arbitrary but clearly erroneous when compared to standard accounting practice.

This Court has made a significant comment on this issue in *Thor Power Tool Co.* v. *Commissioner,* 439 U.S. 522, 58 L. Ed. 2d 785, 99 S.Ct. 773. On page 549 of that opinion, and in commenting on the Black Motor formula for a reserve for bad debts, the Court stated:

> "If a taxpayer's most recent bad debt experience is unrepresentative for some reason, a formula using that experience as data cannot be expected to produce a "reasonable" addition for the current year. If the taxpayer suffers an extraordinary credit reversal (the bankruptcy of a major customer, for example) the "six year moving average formula" will fail. (citing, in footnote 32, *Calavo Inc.* v. *Commissioner,* 304 F. 2d 650, 651-52, 654 n 4, 655 (CA 9 1962). In such a case, where the taxpayer can point to conditions that will cause future debt collections to be less likely than in the past, the taxpayer is entitled to—and

> the Commissioner is prepared to allow—an addition larger than Black Motor would call for."

Both *Thor* and *Calavo* were already on the accrual method of accounting and had an established reserve for bad debts, as is standard accounting practice. In *Thor,* the Court held that the Commissioner did not abuse his discretion by stating that *Thor* did not show that the conditions at the end of 1965 would cause collection of accounts receivable to be less likely than in prior years. (p. 549). However, in *Calavo,* where the Duarte account had become insolvent, the Court reversed and remanded to the Tax Court with instructions that its judgment be vacated and that the cause upon the present record be resubmitted to the Commissioner for an exercise of his discretion free from his erroneous conception that the circumstances particularly affecting a specific debt must be completely disregarded in determining the reasonableness of additions to reserve. (*Calavo,* at 655). In making this decision, the Court stated: (at 655)

> "The difficulty we face is that it is apparent that the Commissioner has, in disallowing any addition to reserve, refused to give any consideration whatsoever to the circumstances affecting the Duarte account. His discretion has thus been exercised under a misapprehension as to the considerations upon which it should be based. This, we feel, requires a reconsideration by the Commissioner of the question as to what under all of the circumstances would be a reasonable addition to reserve and a re-exercise of his discretion upon this question."

Here, again, the Eighth Circuit is in conflict with the Ninth Circuit as shown by the *Calavo* case. We suggest to this Court that a similar remedy be made available to Petitioner as was made in *Calavo.* In *Caldwell,* the Court made their own allowance without remand. In our case, however, Petitioner should be allowed to have a reasonable allowance in the Tax Court based upon the record itself or upon calculation by the

Commissioner of a reasonable allowance for a bad debt deduction for the Sound-On account.

Of course, if this Court decides in favor of Petitioner on Part I of our argument, it will not be necessary to decide this issue.

In summary, the decision of the Eighth Circuit Court of Appeals upholding the Tax Court in not allowing a deduction for the debt of Sound-On was arbitrary and clearly erroneous and in conflict with decisions of the Second and Ninth Circuits on similar questions.

WHEREFORE, Petitioner prays that a Writ of Certiorari issue from this Honorable Court to review the judgment of the Eighth Circuit Court of Appeals in *Record Wide, Inc.* v. *Commissioner of Internal Revenue*, No. 81-821 c(b). In the event that the Petition is granted, Petitioner prays that the decision of the Court of Appeals affirming the judgment of the Tax Court be reversed or, in the alternative, that such decisions be reversed and the cause remanded to the Tax Court for further proceedings to allow a reasonable deduction as a reserve for bad debts for the debt of Sound-On Distributors, Inc.

Respectfully submitted,

CLAUDE HANKS, ESQ. MB#16030
725 Old Ballas, Foreway Bldg.
Creve Coeur, MO 63141
Telephone: (314) 432-1170
Attorney for Petitioner

Of Counsel for Petitioner
LEONARD R. YOCUM, ESQ. MB#15444
725 Old Ballas, Foreway Bldg.
Creve Coeur, MO 63141
Telephone: (314) 432-1170

CERTIFICATE OF SERVICE

I do hereby certify that three true and correct copies of the foregoing brief in the above cause were mailed, postage prepaid, to: Mr. John F. Murray, Acting Assistant Attorney General, Tax Division, United States Department of Justice, Washington, D.C. 20520; and Mr. Jerome D. Sebastian, acting Chief Counsel, Internal Revenue Service, Washington, D.C. 20530; and The Honorable Rex E. Lee, Solicitor General of the United States, Washington, D.C. 20530; by placing same in envelopes so addressed and depositing same in U.S. First Class mail, on this 22 day of November, 1982.

CLAUDE HANKS

APPENDIX A

Record Wide Distributors, Inc.,
Appellant,

v.

Commissioner of Internal Revenue,
Appellee.

No. 81-1853.

United States Court of Appeals,
Eighth Circuit.

Submitted March 10, 1982.

Decided July 14, 1982.

Taxpayer appealed from decision of the United States Tax Court, Forrester, J., upholding assessment by the Commissioner of Internal Revenue of certain deficiencies. The Court of Appeals, Henley, Senior Circuit Judge, held that: (1) Commissioner did not abuse his discretion by requiring use of accrual method to compute taxpayer's tax liability; (2) on basis of accrual accounting method, invoice amounts were properly included in income as accounts receivable upon delivery of merchandise and corresponding reduction of inventory; (3) taxpayer failed to prove that debt owed by one of its major customers was wholly worthless in 1974, as would entitle taxpayer to deduction; and (4) Commissioner did not clearly err in finding that taxpayer failed to show that partial worthlessness of such debt could have been predicted in 1974 with reasonable certainty, as would entitle taxpayer to deduction for partially worthless debt or addition to bad debt reserve for 1974.

Affirmed.

1. Internal Revenue (key) 3103

Commissioner of Internal Revenue has broad discretion to evaluate and modify taxpayer's accounting method in order to insure clear reflection of income, and taxpayer has heavy burden of proving that Commissioner's determination is plainly arbitrary. 26 U.S.C.A. § 446(b).

2. Internal Revenue (key) 3099

Commissioner of Internal Revenue did not abuse his discretion by requiring use of accrual method to compute liability of taxpayer whose normal business practice was to send an invoice with each shipment of records and tapes, but to defer immediate payment in order to allow its customers to return any unsold items, generally 50 to 60%, along with payment for items sold. 26 U.S.C.A. § 446(b).

3. Internal Revenue (key) 3099

Where taxpayer's normal business practice was to send an invoice with each shipment of records and tapes to its customers, but to defer immediate payment in order to allow its customers to return any unsold items, generally 50 to 60%, along with payment for items sold, invoice amounts were properly included in income, on basis of accrual accounting method, as accounts receivable upon delivery of merchandise and corresponding reduction of inventory. 26 U.S.C.A. § 446(b).

4. Internal Revenue (key) 3442

Taxpayer failed to prove that debt owed by one of its major customers was wholly worthless in 1974, as would entitle taxpayer to deduction, where customer attempted to salvage its business for several years and taxpayer continued to deal with customer, albeit on credit basis. 26 U.S.C.A. § 166(a)(1).

5. Internal Revenue (key) 3421, 3427

Commissioner of Internal Revenue is vested with broad discretion to allow deduction for partially worthless debt, or for addition to bad debt reserve. 26 U.S.C.A. § 166(a)(2), (c).

6. Internal Revenue (key) 3442

Commissioner of Internal Revenue did not clearly err in finding that taxpayer failed to show that partial worthlessness of debt owed by one of its major customers could have been predicted in 1974 with reasonable certainty, as would entitle taxpayer to deduction for partially worthless debt or addition to bad debt reserve for 1974. 26 U.S.C.A. § 166(a)(2), (c).

Claude Hanks, Leonard R. Yocum, Creve Coeur, Mo., for appellant.

Glenn L. Archer, Jr., Asst. Atty. Gen., Michael L. Paup, Daniel F. Ross, Michael J. Roach, Attys., Tax Div., Dept. of Justice, Washington, D.C., for appellee.

Before HEANEY, BRIGHT and HENLEY,* Circuit Judges. Judges.

HENLEY, Senior Circuit Judge.

Taxpayer Record Wide Distributors, Inc. appeals the decision of the tax court upholding the Commissioner's assessment of certain deficiencies for the tax years 1972, 1973 and 1974. We affirm.

---

* The Honorable J. Smith Henley assumed senior status on June 1, 1982.

Taxpayer, a Missouri corporation, is a wholesale distributor of records and tapes, and deals primarily in "cut-outs," budget merchandise that the manufacturer is unable to sell at market price. Because cutouts have limited marketability, taxpayer's normal business practice is to send an invoice with each shipment to its customers, but to defer immediate payment in order to allow its customers to return any unsold items, generally fifty to sixty per cent, along with payment of the items sold.[1]

The issues in this case concern taxpayer's method of accounting during the tax years in question. Characterizing this method as a hybrid of cash and accrual methods, the tax court found that Record Wide reduced its inventory when items were shipped to its customers, but recorded sales upon actual receipt of payment.[2] The Commissioner concluded that this hybrid method did not clearly reflect taxpayer's income,[3] *see* 26 U.S.C. § 446(b), and recalculated tax liability for the years 1972, 1973 and 1974, on an accrual basis, resulting in the assessment of deficiencies in the amounts of $92,056.99, $34,444.54 and $21,232.29, respectively.[4]

---

[1] The tax court noted that Record Wide encouraged returns and payments within 120 days of shipment, but often did not receive returns and payments within 120 days and sometimes settlement of accounts extended more than a year from date of sale.

[2] Taxpayer asserts that it used a cash accounting method, but the tax court observed that the evidence supported a finding that taxpayer actually used an accrual method since an accounts receivable ledger was maintained with a separate entry for each customer. However, for purposes of its opinion, the court assumed that taxpayer used a hybrid system.

[3] This conclusion is based, at least in part, on the fact that thirty to thirty-five per cent of returns and payments occurred in the tax year following shipment.

[4] These figures have since been reduced by certain concessions.

[1,2] Record Wide defends its accounting method as consistent with its unique business practices. It is established, however, that the Commissioner has broad discretion to evaluate and modify a taxpayer's accounting method in order to insure the clear reflection of income, and that the taxpayer has the heavy burden of proving that the Commissioner's determination is plainly arbitrary. *Thor Power Tool Co.* v. *Comm'r,* 439 U.S. 522, 532-33, 99 S.Ct. 773, 780-81, 58 L.Ed.2d 785 (1979); *Clement* v. *United States,* 580 F.2d 422, 430 (Ct.Cl. 1978), *cert. denied,* 440 U.S. 907, 99 S.Ct. 1214, 59 L.Ed.2d 455 (1979). The regulations clearly mandate the use of an accrual accounting method for businesses that maintain inventories, unless the Commissioner, in his discretion, authorizes an alternate method. Treas. Reg. § 1.1446—1(c)(2). The tax court concluded, and we agree, that Record Wide failed to establish that the Commissioner abused his discretion by requiring the use of an accrual method to compute Record Wide's tax liability.

[3] Taxpayer's next contention is that even if an accrual method is used, income should not be reported until actual payment is received because until that time the right to receive income in an amount determinable with reasonable accuracy is not established due to the unpredictable precentage of returns. We think that Record Wide has possibly confused the uncertainty of the time and amount of actual payment with the right to receive payment. The tax court found that Record Wide dealt with its customers on a "sale or return" basis, and that the right to receive payment thus arose upon delivery of the merchandise to taxpayer's customers. As indicated, taxpayer reduced its inventory when the goods were shipped, thereby increasing cost of sales; yet taxpayer failed to show that title was retained while the goods were in the possession of its customers. Moreover, as the tax court noted, even if Record Wide dealt on a consignment basis, income would be recorded upon the sale of the goods rather than upon receipt of payment.

We agree with the tax court that, on the basis of an accrual accounting method, the invoice amounts were properly included in income as accounts receivable upon delivery of the merchandise and the corresponding reduction of inventory.

The final issue is whether Record Wide is entitled to a bad debt deduction or a deduction for an addition to a bad bebt reserve for 1974. *See* 26 U.S.C. § 166. In that year, Sound On Tape Distributors, Inc., one of taxpayer's major customers, suffered a serious financial setback and was unable to pay Record Wide the $176,574.22 remaining after all returns were credited. Because income was reported on a cash received basis, Sound On's failure to pay was not charged off by taxpayer in 1974. Taxpayer now contends that if its 1974 tax liability is recomputed on an accrual basis, it is entitled to a deduction under § 166(a)(1) or (2), or (c).[5]

[4-6] Relying on the facts that Sound On attempted to salvage its business for several years and that taxpayer continued to deal with Sound On, albeit not on a credit basis, the tax court concluded, and we agree, that taxpayer has failed to prove that the debt was wholly worthless in 1974, as required by § 166(a)(1).

---

[5] Section 166 provides in pertinent part:

(a)(1) Wholly worthless debts.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts.—When satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

* * * * * *

(c) Reserve for bad debts.—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary) a deduction for a reasonable addition to a reserve for bad debts.

See Riss v. *Comm'r*, 478 F.2d 1160, 1165-66 (8th Cir. 1973). With respect to § 166(a)(2), and (c), we recognize, as did the tax court, that the Commissioner is vested with broad discretion to allow a deduction for a partially worthless debt, *Brimberry* v. *Comm'r*, 588 F.2d 975, 977 (5th Cir. 1979), or for an addition to a bad debt reserve, *Thor Power Tool* v. *Comm'r*, 439 U.S. at 547-48, 99 S.Ct. at 788-89; *Malone & Hyde, Inc.* v. *United States*, 568 F.2d 474, 477 (6th Cir. 1978). Although the Commissioner might have reached a different result, we cannot say that he clearly erred in finding that Record Wide failed to show that the partial worthlessness could have been predicted in 1974 with reasonable certainty. *See Sika Chemical Corp.* v. *Comm'r*, 64 T.C. 856, 863 (1975). We conclude that the Commissioner did not abuse his discretion is disallowing a bad debt deduction or an addition to a bad debt reserve in 1974.[6]

Finding no reversible error, the decision of the tax court, largely for reasons stated by that court, is affirmed.

---

[6] The tax court noted that taxpayer charged the debt off its books in 1978 but did not take a tax deduction. The record does not indicate whether Record Wide has attempted to adjust its tax liability to reflect deduction for this loss in any other year or the extent to which 1978 or other years might still be open for such adjustment. Nor does the record reflect that taxpayer had established and used a bad debt reserve for any of the years at issue.

APPENDIX B

United States Court of Appeals
For the Eighth Circuit

September Term 1981

No. 81-1853

Record Wide Distributors, Inc.,
Appellant,

v.

Commissioner of Internal Revenue,
Appellee.

Appeal from the United States Tax Court

Petition of appellant for rehearing filed in this cause having been considered, it is now here ordered by this Court that the same be, and it is hereby, denied.

August 24, 1982

APPENDIX C

[¶ 81.012] TC Memo 1981-12. RECORD WIDE DISTRIBUTORS, INC. Docket No. 11595-78. 1-12-81. Opinion by FORRESTER, *J.* Years 1972-1974. Decision for Commissioner.

1. Bad Debts—How deduction is taken; specific debt method—determination of worthlessness—effect of creditor's actions—creditor's continued dealings with, or advances to, debtor. "Cut-out" budget record wholesaler wasn't entitled to bad debt deduction in 1974 but was in 1978. Wholesaler continued to deal with retailer until 1978, when they settled $161,000 debt for $5,000 and retailer ceased doing business. Retailer had profitable bootleg business but was stopped by court injunction in 1974. *Ref:* 1981 P-H Fed. ¶14,793(5). Sec. 166.

2. Tax Accounting—Methods of accounting—methods defined—hybrid methods. "Cut-out" budget record wholesaler was required to use accrual method of accounting. Previously used hybrid cash method for sales and accrual method for inventory didn't accurately reflect income and didn't conform to generally accepted accounting methods. Wholesaler deals with retailers on "sale or return" basis with 50-60% return rate. Some returns are in next tax year. This distorts income for corp.'s first year, but new Sec. 458 offers relief and will compensate for previous "bunching" of income. *Ref:* 1981 P-H Fed. ¶20,069(15). See 446.

3. Tax Accounting—Methods of accounting—methods defined—accounting methods clearly reflecting income. "Cut-out" budget record wholesaler must report sales income at time of delivery of goods to retailers. Right to receive payment determines that income has accrued and IRS determined wholesaler must use accrual method. Wholesaler deals with retailers on

"sale or return" basis with 50-60% return rate. It will have deduction for returns. *Ref:* 1981 P-H Fed. ¶20,066(5). See 446.

Official Report

Claude Hanks and Leonard R. Yocum, for the petitioner.

David T. Karzon, Jr., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FORRESTER, *Judge:* Respondent has determined deficiencies in petitioner's Federal income tax for its taxable years 1972, 1973, and 1974, in the amounts of $92,056.99, $34,444.54, and $21,232.29, respectively. The issues presented for our decision are (1) whether petitioner should have reported its income on an accrual rather than the cash method of accounting, (2) whether respondent properly calculated petitioner's increase in accounts receivable for the years in issue and (3) whether petitioner is entitled to a bad debt deduction for its taxable year 1974.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found.

Petitioner, Record Wide Distributors, Inc., is a Missouri Corporation with its principal place of business in Fenton, Missouri. It timely filed its U.S. Corporation Income Tax Returns, Form 1120, for the calendar years 1972, 1973, and 1974 with the Internal Revenue Service Center at Kansas City, Missouri.

Petitioner was incorporated on March 7, 1972, prior to which the business was operated as a sole proprietorship known as Bootheel Records by Gayron Lytle. During the years in issue Gayron Lytle owned 100% of the stock of petitioner and was its

president. His brother, Randall, was vice president and petitioner's managing officer during those years.

Petitioner is a wholesaler in the business of selling phonograph records. 8-track tapes, and cassette tapes to wholesalers and retailers. The bulk of the merchandise sold by it are cut outs. Cut outs are budget products which the manufacturer has not been able to sell in its market. The petitioner assembles cut outs into lots of varying size and then ships them to retailers for sale at highly discounted prices. The nature of cut outs, being less marketable, makes it virtually impossible for a retailer to determine to what extent a given lot of records or tapes will be sold. For this reason petitioner guaranteed its customers that they could return any unsold items for full credit. There are no written contracts between petitioner and its customers, but petitioner has been profitable notwithstanding.

Petitioner's policy has been not to require any payment for records and tapes until the retailer had sold all of the product that it could and returned the unsold merchandise. Although petitioner has a policy whereby it encourages returns and payments within 120 days of shipment, if often does not receive payments and returns for well over 120 days, sometimes even over a year. At the time petitioner shipped goods to a customer an invoice was sent along showing the amount, description, and price of the items sold. Petitioner has historically experienced returns of between 50 and 60 percent. Of the goods shipped by petitioner in any taxable year 30-35 percent of the returns with respect thereto were received by petitioner in a later taxable year (usually within the first 4 months).

One of petitioner's major customers was Sound On Tape Distributors, Inc., a wholesaler of 8-track tapes (hereinafter Sound On). Petitioner maintained the same return policy with Sound On that it did with its other customers. Until 1974 Sound On dealt heavily in what are known as bootleg, duplicate, or

counterfeit tapes. In February 1974 Sound On was enjoined from selling such tapes. As a result, Sound On's inventory was nearly worthless and it returned the tapes to petitioner. After crediting Sound On for these returns Sound On owed petitioner $176,574.22. Although Sound On's financial position was unstable its management attempted to salvage the business. Petitioenr no longer extended Sound On credit after 1974 but required payments (including return credit) at least equal to the amount of merchandise shipped prior to or at the time of shipment. Several of Sound On's checks bounced. Thus, starting in 1976, petitioner required cash only upon delivery.

In 1978 petitioner and Sound On executed an agreement settling the latter's outstanding debt which had been reduced to the principal amount of $161,000 owed to petitioner, for $5,000. Sound On ceased doing business shortly after the execution of this agreement. On its books petitioner wrote off the uncollected Sound On debt in 1978, however, it has never been written off for Federal income tax purposes.

During the years in issue, and before, petitioner operated on a hybrid method of accounting. It maintained an inventory on its books for determining its cost of sales[1] but determined its sales on the cash basis. That is, petitioner posted sales only as it received cash. Furthermore, petitioner did not include goods received from the manufacturer but not paid for on its Schedule A as "Merchandise bought for Manufacturer or Sale."

Respondent has determined that petitioner's method of reporting income from sales, i.e., the cash receipts and disbursements method, does not clearly reflect income and that an accrual method of accounting does clearly reflect income.

---

[1] Petitioner's inventory at the end of a taxable year included only those items situate in its warehouse. None of the records and tapes in the hands of its customers were included in its inventory.

Consequently, respondent increased petitioner's income for taxable years 1972, 1973, and 1974 by $191,775.41, $71,759.47, and $4,233.93, respectively.[2]

OPINION

Petitioner's primary contention is that its hybrid method of accounting and reporting income during the years in issue was consistent with its unique method of doing business since prior to the time of its incorporation. Furthermore, it argues that its methods, clearly reflect income and are in conformity with generally accepted accounting principles.

Respondent maintains that since petitioner must keep inventories for each taxable year in issue[3] it must report purchases and sales using an accrual method of accounting.[4]

Section 446(a)[5] provides the general rule that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. Section 446(b) provides two exceptions to this general rule. Where no method of accounting has been regularly used by the taxpayer, or where the method used by the taxpayer does not clearly reflect income, the computation of taxable in-

---

[2] These adjustments are as reflected in respondent's deficiency notice. Since that time respondent has made certain concessions, the effect of which is to reduce these figures.

[3] See Section 1.471-1, Income Tax Regs. Petitioner does not dispute the necessity of inventories for the correct reflection of income.

[4] Respondent asserts, and there is substantial evidence, that petitioner has actually kept its books on an accrual method of accounting. However, for purposes of this opinion we will proceed on the basis that petitioner's books and records were maintained on a hybrid system.

[5] All statutory references are to the Internal Revenue Code, as amended and in effect for the taxable years in issue.

come shall be made under such method as in the opinion of the Commissioner does clearly reflect income. See 446(b). The respondent's determination pursuant to his authority under Section 446(b) is presumptively correct and must be upheld unless the petitioner has proved it clearly erroneous or arbitrary. Brooks-Massey Dodge, Inc. v. Commissioner, 60 T.C. 884, 891 (1973). The respondent's discretion in matters of accounting methods is very broad. See Commissioner v. Hansen, 360 U.S. 446 [3 AFTR 2d 1690] (1959).

Where one's method of accounting does not, in the opinion of the Commissioner, clearly reflect income the respondent may require the use of such method as does clearly reflect income. Sec. 446(b). This is true regardless whether the petitioner has consistently used some other method. See Iverson's Estate v. Commissioner, 255 F.2d 1, 5 [1 AFTR 2d 1650] (8th Cir. 1958). To allow otherwise would lead to the untenable conclusion that a taxpayer has unfettered discretion to select any method of accounting for tax purposes so long as it conforms to that used for bookkeeping purposes. Petitioner has entered no evidence that its hybrid method of accounting is in accord with generally accepted accounting methods.[4] Assuming, arguendo, that petitioner's method is proper for purposes of financial accounting this fact is not determinative for tax accounting purposes. See Thor Power Tool Company v. Commissioner, 439 U.S. 522 [43 AFTR 2d 79-362] (1979). It is incumbent upon petitioner to prove respondent's determination arbitrary or clearly erroneous. See Thor Power Tool Company v. Commissioner, *supra*. This, petitioner has not proved.

---

[4] Petitioner kept an accounts receivable ledger with a separate entry for each customer wherein appeared the headings "Total Accounts Receivable Balance", "Current Amount Due", "30-60 Days", "60-90 Days", and "Over 90 Days". This was set up at the time of petitioner's incorporation by Price Waterhouse, a respected international accounting firm. The use by Price Waterhouse of accounts receivable records indicates that an accrual, not the cash method of accounting, may well be the generally accepted accounting method for petitioner's business.

In his deficiency notice respondent determined that petitioner's computation of its income on the cash receipts and disbursements method does not clearly reflect income. Petitioner does not dispute that it must maintain inventories since the sale of merchandise is a principal income-producing factor of its business. See Secs. 1.446-1(a)(4)(i); 1.471-1, Income Tax Regs. Where inventories are required the regulations mandate the use of an accrual method of accounting for purchases and sales. Sec. 1-446-1(c)(2)(i), Income Tax Regs. This principle has been consistently upheld by the courts. See, e.g., Niles Bement Pond Company v. United States, 281 U.S. 357 [8 AFTR 10895] (1930); Wilkinson-Beane, Inc. v. Commissioner, 420 F.2d 352 [25 AFTR 2d 70-418] (1st Cir. 1970); Iverson's Estate v. Commissioner, 255 F.2d 1 [1 AFTR 2d 1650] (8th Cir. 1958); Caldwell v. Commissioner, 202 F.2d 112 [43 AFTR 271] (2d Cir. 1953); Ezo Products Company v. Commissioner, 37 T.C. 385 (1961). In light of these cases we can in no way find that respondent's determination is either arbitrary or clearly erroneous. Therefore, respondent's determination that petitioner must report its income on the accrual method must prevail.

Alternatively, petitioner maintains that if it is required to report income on an accrual method of accounting it should nonetheless not report income until cash is received because, in light of its return policy, all events had not occurred which establish its right to receive any certain amount of income. We do not dispute that income is to be included only when all the events have occurred which fix the petitioner's right to receive such income and the amount thereof is determinable with reasonable accuracy. Spring City Foundry Company v. Commissioner, 292 U.S. 182 [13 AFTR 1164] (1934); Sec. 1.446-1(c)(1)(ii), Income Tax Regs. However, it is clear that petitioner was dealing with its customers on a "sale or return"

basis rather than on a consignment basis.[7] The fact that a buyer may return any part of the goods shipped but unsold does not render the transaction a consignment. See Mo. Ann. Stat. Sec. 400.2-327(a). Under a sale or return system the petitioner is required to report the income form the sale upon delivery of the goods to its customers. The right to receive payment, not the actual receipt, determines whether income has accrued and must be included in the gross income of an accrual basis taxpayer. Commissioner v. Hansen, 360 U.S. 446 [3 AFTR 2d 1690] (1959); Spring City Foundry Company v. Commissioner, 292 U.S. 182 [13 AFTR 1164] (1934). Petitioner's right to receive payment is unaffected by predicted uncollectability, no matter how certain. See Spring City Foundry Company v. Commissioner, *supra*. As stated in that case "if such accounts receivable become uncollectible, in whole or part, the question is one of deduction which may be taken according to the applicable statute." Id. at 185.[8]

---

[7] Had petitioner been operating on a consignment basis it would have reported income when the retailer sold the goods, not when petitioner was paid. Furthermore, petitioner has not shown that it retained title to the goods while in the retailer's hands. Randall Lytle noted only that risk of loss issues, were only discussed with retailers after a loss by fire or otherwise occurred. The parties would work out the burden of loss at that time. Also, if petitioner had been on the consignment basis with its customers it would have had to include all consigned goods in its ending inventory. Sec. 1.471-1, Income Tax Regs. This petitioner did not do. Duesenberg, Inc. v. Commissioner, 84 F.2d 921 [18 AFTR 251] (7th Cir. 1936). See generally J. J. Little and Ives Co., Inc. v. Commissioner, T. C. Memo. 1966-68 [¶66,068 P-H Memo TC]. Finally, under Missouri law (the Uniform Commercial Code) petitioner unquestionably operated under a "sale or return", as opposed to a consignment, basis. Mo. Ann. Stat. Secs. 400.2-326, 400.2-327.

[8] Under Sec. 458(a) (effective only for taxable years beginning after September 30, 1979) an accrual-basis distributor of records may elect to exclude from gross income attributable to merchandise returned within four and one half months after the close of the taxable year in which the sales were made. Although not effective for the taxable

The final issue for our decision is whether petitioner is entitled to a bad debt deduction for the debt of Sound On in 1974. Petitioner asserts that due to the prohibition against the sale by Sound On of duplicate tapes in 1974 it (Sound On) was ruined financially, rendering its debt owed to petitioner worthless at that time. Petitioner bases this conclusion on the fact that Sound On's only assets were worthless inventory and tape racks and that is Sound On had liquidated in 1974 the bulk of its accounts payable to petitioner could not have been paid.

It is respondent's position that the debt owed to petitioner by Sound On did not become worthless until 1978 at which time Sound On ceased doing business and at which time petitioner settled its account with Sound On for $5,000.

Section 166[9] provides that a corporation may deduct bad debts for the taxable year when, and to the extent, they become wholly or partially worthless. The burden of proving the date or

---

years in issue, the legislative history indicates that under pre-section 458 law petitioner is required to include the income from the sale of records in gross income when they are shipped to retailers, irrespective of the number of returns. H. R. Conf. Rep. No. 95-1800, 95th Cong., 2d Sess. 279, 1978-3 (Vol. I) C. B. 521 (1978).

Although we sympathize with the petitioner's plight that the effect of pre-section 458 law will result in a "bunching" of income in its taxable year 1972—we note that petitioner will enjoy an offsetting decrease in income for its taxable year 1980 due to section 458. For years after 1980 the effect of section 458 will be to more accurately reflect petitioner's income than at any time in the past.

[9] SEC. 166. BAD DEBTS.

(a) General Rule.—

(1) Wholly worthless debts.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts.—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

worthlessness is on the petitioner. Mueller v. Commissioner, 60 T. C. 36, 41 (1973); Perry v. Commissioner, 22 T. C. 968 (1954). In the instant case it is clear that Sound On's debt was not wholly worthless in 1974. Courts are reluctant to consider the debt of a business wholly worthless where it has been able to perpetuate itself as a going concern. Riss v. Commissioner, 56 T. C. 388 (1971), aff'd 478 F.2d 1160 [31 AFTR 2d 73-1235] (8th Cir. 1973). Sound on continued in business for almost four years after the time at which petitioner asserts its debt became worthless. We do not suggest that Sound On was in healthy financial condition but we do not consider Sound On's attempts, to keep its business alive and growing unrealistic. The fact that Sound On could not have paid its debt during 1974 is not determinative. L. A. Shipbuilding and Drydock Corp. v. United States, 289 F.2d 222 [7 AFTR 2d 984] (9th Cir. 1961). Petitioner continued to do business with Sound On after 1974. Although it would not extend Sound On credit it did accept its checks for approximately 2 years even though several bounced. On the facts presented we cannot find that Sound On's debt to petitioner became worthless in 1974.

Alternatively, petitioner on brief asserts that Sound On's debt became partially worthless in 1974. Respondent maintains that "the Commissioner *cannot* allow a partial bad debt deduction [under Sec. 166(a)(2)] in an amount which exceeds the part *charged off* by the taxpayer within the taxable year of the claimed worthlessness."[10] In the instant case petitioner charged off the entire debt owed by Sound On in 1978.[11] No part was charged off before that time. The petitioner alleges that had it been on an accrual method of accounting for 1974 it would have charged off the debt at that time.

---

[10] Bender v. Commissioner, T. C. Memo 1967-26 [¶67,026 P-H Memo T. C.].

[11] It should be noted that although petitioner charged the debt off its books in 1978 it did not take an income tax deduction for it in 1978.

We need not consider whether under circumstances where the respondent changes the petitioner's method of accounting from cash basis to an accrual basis, the petitioner should be allowed to retroactively charge off some part of a debt which became worthless in a prior year and which would have been charged off had the petitioner consistently maintained an accrual method of accounting.[12] This Court has long taken the position that section 166(a)(2) confers broad discretion upon the respondent to determine deductibility of debts alleged to be partially worthless. See Sika Chemical Corp. v. Commissioner, 64 T.C. 856, 862-63 (1975) and cases cited therein.[13]

Respondent's determination must be upheld unless found to be plainly arbitrary or unreasonable. Id. To overcome the respondent's presumption of correctness, it is the petitioner's burden to establish that in the year for which the partial worthlessness is claimed the amount of such worthlessness could be predicted with reasonable certainty. Id. This the petitioner has failed to do. Thus, we must uphold the respondent's determination that petitioner is not entitled to deduct any portion of the Sound On debt in 1974.

Based on the foregoing.

Decision will be entered for the respondent.

---

[12] Cf. section 481(a). We note that Bradstreet Co. v. Commissioner, 65 F.2d 943, 945 [12 AFTR 903] (1st Cir. 1933), lends some support to petitioner's assertion that the respondent as well as the petitioner bears a burden to select a method of accounting which clearly reflects income. See also Gordon v. Commissioner, 63 T.C. 51, 73 (1974); Harbin v. Commissioner, 40 T.C. 373, 376-77 (1963).

[13] See also Production Steel Inc. v. Commissioner, T.C. Memo, 1979-361 [¶79,361 P-H Memo T.C.].

APPENDIX D

UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

Docket No. 11595-78

Record Wide Distributors, Inc.,
Petitioner,

v.

Commissioner of Internal Revenue,
Respondent.

DECISION

Pursuant to the determination of the Court, as set forth in its Memorandum Findings of Fact and Opinion filed January 12, 1981, it is

ORDERED AND DECIDED: That there are deficiencies in petitioner's Federal income tax for its taxable years 1972, 1973, and 1974, in the amounts of $92,056.99, $34,444.54, and $21,232.29, respectively.

/s/ Bruce M. Forrester
Judge

Entered: January 12, 1981

APPENDIX E

UNITED STATES TAX COURT

Docket No. 11595-78

Record Wide Distributors, Inc.,
Pettioner,

v.

Commissioner of Internal Revenue,
Respondent.

DECISION

Pursuant to the opinion of the Court filed January 12, 1981, as revised by order dated February 11, 1981, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there are deficiencies in income tax due from the petitioner for the taxable years 1972, 1973, and 1974 in the amounts of $53,947.55, $47,985.17, and $31,203.54, respectively.

/s/ Bruce M. Forrester
Judge

Entered: April 10, 1981

• • • • •

APPENDIX F

[48]* Lytle - Direct

A. At the end of '74, I put Sound On on a method whereas, any monies that I received plus any credits I received, had to at least, equal the purchases that I sold to them.

Q. In other words, you would not ship them any merchandise over and above their returns, and their cash paid?

A. That's correct.

Q. And you didn't take into account at that time, bad debts, did you?

A. No, I did not.

Q. So, you did not set up any bad debt for Sound On?

A. No, I did not.

Q. Do you know, who at the end of '74, owned Sound On?

A. Don Holtzman.

Q. Don Holtzman. Previous to that time, your brother, Gayron Lytle had been a stockholder in that company. Is that right?

A. I would assume so. I —

Q. Were you ever a stockholder in it?

A. No, I was not.

Q. Did you ever have anything to do with it —

A. No.

---

* Numbers appearing in brackets in text indicate page numbers of original stenographic transcript of testimony.

Q. — I mean, other than sell it?

A. No.

• • • • • • •

[85] Mr. Wollbrinck: James H. Wollbrinck, 4550 McPherson, St. Louis, Missouri.

The Clerk: Spell your last name, please.

Mr. Wollbrinck: W-o-l-l-b-r-i-n-c-k.

The Clerk: Thank you.

JAMES H. WOLLBRINCK,

called as a witness, having been duly sworn, took the stand and testified as follows:

Direct Examination

By Mr. Hanks:

The Clerk: 18 marked for identification.

Mr. Hanks: Now, again for the record, state your name and address, sir.

A. James H. Wollbrinck, 4550 McPherson, St. Louis, Missouri.

Q. And what is your business or occupation or profession?

A. I'm an attorney.

Q. And you are licensed to practice law in the State of Missouri, are you?

A. Yes, sir.

Q. And how long have you been licensed as an attorney in the State of Missouri?

A. Since 1955.

Q. And since that time, Mr. Wollbrinck, have you specialized in any particular facet of the legal business?

[86] A. I've been engaged in the active practice of law since 1959, in my own office. The practice — I'm a general practitioner, but I tend to do a great deal of business, business related activities. I do very little, if any, criminal, personal injury and that sort of thing.

Q. And do you have — in your business, do you prepare income tax returns and do tax work?

A. Yes, sir, substantially.

Q. And in that particular facet of your business, were you associated with a gentleman by the name of Gayron Lytle?

A. Yes.

Q. Do you recognize the name Gayron Lytle, as the same gentleman mentioned as a majority stockholder of the petitioner in this case, Record Wide Distributors?

A. Yes, sir.

Q. And is he — were you also acquainted with Randall Lytle, the gentleman who just testified here?

A. Yes, sir.

Q. And he's the brother of Gayron Lytle, is that correct?

A. To the best of my knowledge.

Q. Now, did you prepare the income tax returns for the year 1969, for Gayron Lytle?

A. Yes.

* * * * * * *

[88] Q. And when you prepared his income tax return, did you and he discuss this return policy?

A. Yes. Because it had material bearing upon what income he actually would have. And in attempting to fix his tax returns, of course, I'd have to know just how he reported income, when he got it, and that sort of thing.

Q. Now, when you prepared those returns in '69, did you allow for accounts receivable and accounts payable?

A. No.

Q. Now, can you tell us why you did not do that?

A. There was no way of knowing — first off, traditionally, as long as I had done any work for him, he was always on the cash basis. As I said, the business started very small, and of course then, gradually increased. He was a good businessman, he worked hard. He — and the nature of his business changed also, so we had started out on the cash basis, and tended to stay with it, because we found that this accurately reflected his income.

Q. Now, was this — was there an audit done on his taxes for the year 1969?

A. Yes.

Q. And were you involved with that audit?

A. The people from the Service were in my office for about two days.

Q. I'm going to hand you what has been marked [89] Petitioner's Exhibit number 18. And ask you if you can identify that for the Court?

A. Yes, sir. This was the ultimate — one of the ultimate results of the audit. There were some changes made in depreciation. I had depreciated some racks for the whole year, when in

fact, they were bought during the year, so were were only allowed to take a certain number of months on two set of racks, and on a truck. The disallowance of the over-depreciation, partial over-depreciation then of course, led to a greater reportable income and it raised the tax.

Q. And is that document signed by the agent who did the audit?

A. It's a carbon copy, it appears to be signed by Victor J. Beck, St. Louis, Missouri, dated November 19th, 1970.

Q. And at that time, was that business — the record business, the sale of wholesale records?

A. Yes, sir.

Q. And at that time, did Gayron Lytle maintain an inventory?

A. Did he have merchandise to sell?

Q. Yes.

A. Yes, as far as I know.

Q. And, a matter of fact, you took inventory into [90] account when you prepared his taxes, did you not?

A. Yes, sir. We had to do that.

Q. And that — okay. I'll offer into evidence, Your Honor, Petitioner's Exhibit 18.

The Court: Mr. Karzon?

Mr. Karzon: Your Honor, I have no objection to this exhibit. But I think Mr. Hanks should state for the record whether he holds the Power of Attorney for Mr. Gayron Lytle, for the taxable year, 1969.

Mr. Hanks: I hold the Power of Attorney for Mr. Gayron Lytle for any —

Mr. Karzon: Okay.

Mr. Hanks: — years.

The Court: Very well. It'll be admitted, without objection.

Mr. Hanks: Now, have you prepared tax return—

The Court: Is it Gayron or Gaven?

Mr. Hanks: Gayron, Gayron.

The Court: How do you spell it?

Mr. Hanks: G-a-y-r-o-n.

The Court: G-a-y-r-o-n. Very well.

Mr. Hanks: Now, Mr. Wollbrinck, have you prepared income tax returns for persons other than Mr. Gayron Lytle?

A. Oh, yes.

Q. Have you prepared returns for corporations?

[91] A. Certainly.

Q. Have you prepared returns for individuals?

A. Yes.

Q. And have you prepared returns wherein the taxpayer maintain an inventory?

A. Sure.

Q. Have you prepared tax returns wherein the taxpayer had accounts receivable and accounts payable?

A. Yes.

Q. Have you prepared returns on both the cash and the accrual basis?

A. Yes.

Q. Are you therefore, familiar with the accrual and the cash basis?

A. Reasonably familiar, yes.

Q. And having prepared the returns for Mr. Gayron Lytle, who later turned that business into Record Wide Distributors, do you have an opinion as to whether or not, the manner in which you prepared the returns for 1969, taking into account, the inventory, but not taking into account, accounts receivable and accounts payable, properly and accurately reported the income of Mr. Gayron Lytle?

A. Yes, I do have an opinion.

Q. And what is that opinion?

A. My opinion is yes, it did accurately reflect the [92] taxable income for the taxpayer.

Q. Do you have an opinion whether or not, there would be any other way to report the income, and — on an income tax return of Mr. Gayron, and accurately report it?

A. Not the way the business was run, no, sir.

Q. Now, you are acquainted with accounts receivable, and as a lawyer, and as someone experienced in preparing tax returns, for both corporate and personal taxpayers, can you give us your opinion as a lawyer, as to what the definition of a tax — of accounts receivable would be?

A. My understanding of it, Mr. Hanks, is that a receivable would be money that is definitely — well, I can't say definitely I do, because this presupposes that the person — the creditor —

the debtor, let us say, might contest that he owes it to you. But I think in a pure legal or an accounting sense, an account receivable is money owed to you, without any question of fact that it is owed. The amount may be in contention. The terms of when it should it be paid may be in contention, but I think that it's money that is owed to you. I think, let's put it that way.

Q. Did Mr. Gayron Lytle, as he was doing business then, and as you know him to be doing business today, from hearing the testimony, have such an accounts receivable?

A. Not to my knowledge. It did not come to my attention.

* * * * * * *

[101] Mr. Karzon: Yes, Your Honor.

Mr. Hanks: Certainly.

The Court: Very well, you're excused, sir.

The Clerk: Raise your right hand. You do solemnly swear the testimony you are about to give to the Court in this case, shall be the truth, the whole truth, and nothing but the truth, so help you God?

Mr. Robley: I do.

The Clerk: Be seated, please.

H. KEITH ROBLEY,

called as a witness, having been duly sworn, took the stand and testified as follows:

Direct Examination

By Mr. Hanks:

Q. Would you state your name, please?

A. My name is H. Keith Robley.

Q. And your business or occupation?

A. Managing partner of Robley and Company, certified firm of public accountants.

Q. And —

The Reporter: Would you spell your last name, please?

The Witness: Robley —

The Reporter: Your last name.

The Witness: My last name is Robley.

The Reporter: Okay.

[102] The Witness: It's R-o-b-l-e-y.

The Reporter: Thank you.

Mr. Hanks: And, Mr. Robley, as such, are you a CPA?

A. Yes, I am.

Q. And what sort of schooling —

The Court: I don't think we have his address yet.

The Clerk: What's your address?

The Witness: My home address is 1216 Bluegrass Drive, St. Louis, Missouri, 63137. My business address is 324 Mansion House Center, St. Louis, Missouri, 63102.

Mr. Hanks: All right. Now, Mr. Robley again, what education did you have prior to becoming a CPA?

A. I'm a graduate of the University of Missouri's business school.

Q. And after that, then you worked, I guess for a certain length of time, prior to becoming a CPA?

A. Approximately three to four years.

Q. And then you are admitted as a CPA in the State of Missouri?

A. Yes, I am.

Q. Any other states?

A. Our firm is, but I'm not personally.

Q. How many members are in your firm?

A. Between 12 and 15, depending on how you count the [103] part time people.

Q. I see.

A. Now, Mr. Robley, as a CPA, and as managing partner of a CPA firm, have you had experience preparing returns and doing audits for businesses?

A. Yes, I have.

Q. For how many years?

A. Since 1956, either for someone else or for the firm of Robley and Company.

Q. I see. And, you do have an occasion to — during that period time, to do audits and income tax returns on the basis of the accrual system?

A. Yes.

Q. And do you also do returns on the cash system?

A. Yes.

Q. Mr. Robley, would you tell us what the accounting definition of the accrual system is?

A. Well, the accrual system is probably a better method of maching costs against revenue, and it is basically used in accruals and different types of accountant adjustments to match income against expenses. A more thorough, I would say, matching of income and expenses, than the cash basis.

Q. Is there any such thing as a — doing your accounting and bookeeping on a true, strict accrual system?

* * * * * * *

[107] Q. Now, we've heard a definition of accounts receivable by an attorney, Mr. Wollbrinck. Can you tell the Court what, in your opinion, based on your accounting experience, an accounts receivable is?

A. Well, it's certainly something that you can reasonably expect to collect, and you wouldn't want to have anything on your balance sheet that you could not reasonably expect to collect. And, the normal practice is, to reduce whatever is an expected accounts receivable, by returns, for example, allowance for bad debts. But I think one of the problems we have with the definition of accounts receivable. I don't think even though, they were described as accounts receivable on the books at Record Wide, that they were as such accounts receivable. Because there was no contracts or real contracts or obligation between the person buying the merchandise and Record Wide, that they had pay X number of dollars for it.

Q. Normally, when you are preparing returns for a company, and you have an accounts receivable, can you place a value on that accounts receivable?

A. Yes. Very definitely in a certified audit, why [108] we'd send out confirmations of accounts receivable, for example. And require the people receiving the confirmation— they'd return it and state that they — this money was owed to a particular company, and I'm sure in this instance, why none of

these people, the customers of Record Wide, would do such a thing.

Q. In other words, then the accounts receivable as shown — for instance, on Exhibits R and S, at the bottom of R and S, Mr. Robley. Would you, as an accountant, be able to certify, based on what you know of their businesses, the value of those receivables?

A. Well, the figure here shown at 12-30-72 is $207,775.41. Of course, there's no way that you could certify that as being a collectable balance.

Q. Is that due to this return policy that they had?

A. Partially, because — and also bad debts and again, I mean, is the money really owed to Record Wide, as of December 31st? I think that's another problem we have here. Normally, in an accounts receivable situation, why there is a creditor-debtor obligation. And the money is due to the creditor. In this case, I don't think that relationship exists, really.

Q. In other words, here — did you understand that these accounts receivables or alleged accounts receivable, or accounts, whatever you call them, there was no definite **[109]** obligation to make payment on them?

A. That's my understanding.

Q. And, is that still the way the company does busines?

A. It's my understanding, it is. Again, I'm not that familiar with the interactions —

Q. I understand.

A. — but it's my understanding.

Q. But you're still doing their bookkeeping —

A. Very definitely, we are.

Q. — their auditing —

A. Yes.

Q. — and their accounting?

A. Right.

Q. Now, then, Mr. Robley, based on your experience as a CPA, and managing partner of a CPA firm here in St. Louis, and having been in business since 1956, and doing auditing and CPA work for various and sundry companies, both on the cash and the accrual system, and based on your knowledge of Record Wide Distributors, at the years '73 and '74, and what you could observe about the '72 return, do you have an opinion as to whether or not, the manner in which they reported their income accurately portrayed their actual income?

A. I think it does in a much better sense, than showing [110] what is considered an accounts receivable. I think that it does reflect their income. It's based though, on the fact that accounting is an art, rather than a science, and it certainly more reflects their income, than including a misnomer figure that's called accounts receivable. There's no question in my mind about that.

Q. In other words, do you feel that an accounts receivable as you understand it, as an accountant, if you used that, that you — based upon what you see on these exhibits —

A. You would grossly distort the income or the loss by including that figure.

Q. In other words, you could grossly distort either income or loss?

A. Right.

Q. Is that correct?

A. Very definitely.

Q. And would it be sort of a hit or miss affair, guesswork?

A. Well, it would have to be.

Mr. Karzon: Objection, Your Honor. We're asking leading questions again.

Mr. Karzon: I'll withdraw it.

The Court: I don't think that was leading. He may answer.

[111] Mr. Hanks: Go ahead.

The Witness: Will you repeat the question, please?

Mr. Hanks: I said, would it be sort of — if you had to use the accrual, and call these accounts receivable, when you prepared the returns for Record Wide, would you be required to guess as to what the actual value of those receivables were?

A. Well, you'd have to try to make a reasonable estimate, and I wouldn't even know how to go about that.

Q. In other words, you would have — because of this return policy, there'd be no way that you could definitely report their income? Is that right?

Mr. Karzon: Objection, on the same grounds.

The Court: Overruled.

Mr. Hanks: Is that right, Mr. Robley?

A. In my opinion, yes.

A. In your opinion. And that opinion is based on your experience as an auditor?

A. Yes.

Q. Let me ask you this, Mr. Robley. Since 1956, in the companies that you have handled, have you ever run across a similar company, doing business in this manner?

A. No, I haven't. It's a very, very unique situation and I was — you know, my opinion has changed, you know, throughout the years I became acquainted with the company, [112] exactly the way they operated. And certainly, your original thought is, that they should very definitely be on the accrual basis—which but — it's my thought now, that they are in essence, on the accrual basis, by having the inventory shown on the tax return. Because there's no company that has a true cash or accrual basis. There's always a hybrid type of a method. And I do feel, in all sincerity and honesty, that by having the inventory on the tax return, we are in essence, on the accrual basis.

Q. You're reporting income as accurately as you know how to do it?

A. Very definitely. I'm not pleased, don't misunderstand me. I think that you could spent a lot of time and work, you may come up with, you know, let's say accruing vacation pay, and there's all kinds of things you might come up with to come up with a different figure, but I think it reasonably reflects income.

Q. But certainly, there'd be no way to include these alleged receivables?

A. Well, I wouldn't say there's no way to do it, I would say that, to include them at all, you'd have to make some reasonable estimates. Again, I don't exactly know how you'd go about it, because certainly an accounts receivable, or money due Record Wide, you'd have to assume a reasonable collection time and this type of thing, and apparently here, [113] you have situations where it may be a year or two, or three years, before Record Wide receives any money on a potential sale, if they receive it at all. So it'd be very difficult to do.

Q. And with this new statute that the Congress has passed, allowing returns within 4½ months, would that solve the situation?

A. No, not at all, for Record Wide. And certainly when they passed that statute, they did not have Record Wide in mind, they were thinking about different types of record companies, other than Record Wide. I think Record's Wide is a very unique company. I know of no other record company that sells merchandise like that, and out of curiosity, I asked Mr. Lytle, and he doesn't know of anybody else that does it the same way either. It just —

Q. I have no further questions. Thank you, Mr. Robley.

The Court: Mr. Robbley, you've testified that valuing and including these receivables, would distort income. Would it, in your opinion, do more than accelerate the realization of income, using realiziation of income as a term of art? In other words, it's realized. Would it do more than accelerate it?

The Witness: Very definitely, Your Honor, because of the fact you'd be including figures that may never be • • •.

• • • • • • •

[134] Mr. Hanks: And what was the obligation on that balance sheet?

A. The obligation — they're showing accounts payable here of $173,312.00.

Q. If they had liquidated everything, and got just what they told you on the balance sheet, would there have been a certain amount of that obligation that could not have been paid?

A. I would say the biggest part of it would not — could not be paid.

Q. How much — would — about $107,000.00 difference?

A. Well, I think it would be — that's shown a deficit — here's $107,000.00 shown as the deficit in retained earnings. But, whenever you go to liquidate a corporation, and this is what happened in bankruptcy, is that, you liquidate the assets and pay the creditors. And I think in liquidation, why the accounts receivable that's shown here [135] and the inventory would be a lot less than stated on this balance sheet.

Q. Does that balance sheet show any real estate, or anything of this sort?

A. It shows no real — the only real — there's no real assets, personal property down here, which I think is racks, shows a net value of $2,060.00, and I'm sure there again, that that's what it would be actually worth in a bankruptcy type situation, it'd be a lot less than that.

Q. Now, one other question. The Court brought up the dance lesson case. Or the dancing — maybe His Honor knows something about that. But, let me ask you, I assume that the dance lessons was a situation where Arthur Murray took people in and signed contracts and said, "We'll give you 10 dance lessons for a $100.00." And the Government said, "Okay, that's $100.00 earned." Now, is that any different than the situation with Record Wide?

A. I would assume there's a lot of difference, because I cannot believe that Arthur Murray could reasonably expect to collect their money, unless they had a contractual obligation with the people that were going to —

Q. Even though Arthur —

A. — take the dance lessons.

Q. Now, here, Record Wide sends out records. Do you see any difference, from accounting standpoint, in the two?

* * * * * * * *

[148] Holtzmann - Direct

Q. Okay. Now then, you operated on that basis for how long?

A. Approximately three years.

Q. Now, was your method of purchases from Record Wide changed at any time?

A. Later in '74.

Q. Later in — during the year '74?

A. Uh-huh.

Q. And what was the reason for that, if you know?

A. I didn't have any money. It was —

Q. Now, you say I didn't have money, you mean Sound on?

A. Sound On.

Q. Had no money?

A. Right.

Q. Did Sound On own any properties in '74?

A. No, sir.

Q. Real estate? What was Sound On's assets, what did it consist of in '74?

A. Some racks. And basically, the inventory that we had.

A. Now then—what was this exhibit, do you know?

Mr. Karzon: It's 8-H.

[149] Mr. Hanks: I don't have a copy marked as an exhibit. May I borrow yours just a minute? Mr. Holtzmann, I'm going to

hand you what has been marked Exhibit 8-H for purposes of this hearing, and ask you if you can tell us what that is?

A. Looks like a merchandise purchase and —

Q. Is that your account?

A. Yes, it is.

Q. All right. Now, turning over to some period in '74. Was there some changes in the way you made your payments?

A. Yes. I started paying for a product when I got it. When I picked it up.

Q. In other words — and at that time, would you bring in your —

A. Returns?

Q. — merchandise — your returns?

A. Uh-huh. I'd have to pay for the difference.

Q. I see. And was that carried until you went out of business?

A. Yes, sir.

Q. At any time, after the middle of 1974, Mr. Holtzmann, did you have any monies to pay the amount owed Record Wide?

A. No, sir.

[150] Q. Even if you returned all the merchandise?

A. Yes, sir, that would have been correct.

Q. You still would not have?

A. That's correct.

Q. Is that correct?

A. That is correct.

Q. And, had they of filed suit against you, they — against Sound on Tape Distributors, they would have recovered nothing, is that right?

A. Yes, sir.

Mr. Karzon: Objection, leading question.

The Court: Don't lead the witness.

Mr. Hanks: Okay. Well, what was your — what did you assets consist of in the end of '74?

A. Assets were the merchandise that was out in the stores, and the racks.

Q. Now —

A. I had trucks, but I leased those.

Q. You leased the trucks. Now then, did you handle a merchandise known as Quali Sonic?

A. Yes, sir.

Q. Can you tell the Court what the Quali Sonic merchandise was?

A. Quali Sonic merchandise was duplicate merchandise and it was —

[151] The Court: Duplicate merchandise?

The Witness: Yes, sir.

The Court: Very well.

Mr. Hanks: Is this also commonly known as bootleg tapes?

A. Yes, sir.

Q. And, your purchases from Record Wide, did that consist in part of Quali Sonic?

A. Yes, sir.

Q. Do you have any idea how much Quali Sonic material you had purchased?

A. No, sir. But it was an awful lot.

Q. Was an awful lot. And, what happened to the Quali Sonic material?

A. Well, it wasn't worth anything when the law passed, so we had to take it all in and return it.

Q. And you returned it?

A. Yes, sir.

Q. Is that correct? It had a worthless value?

A. Couldn't sell it.

Q. Couldn't sell it?

A. Couldn't do anything with it, you had to eat it.

Q. I have no further questions.

The Court: You may cross.

* * * * * * * *

[183] ROSE MARIE L. STUCKEY,

called as a witness, having been duly sworn, took the stand and testified as follows:

Direct Examination

By Mr. Karzon:

The Court: Your last name is Stuckey?

The Witness: Stuckey.

The Court: Rose Marie, what was the middle name?

The Witness: Middle initial is L.

The Court: L., very well. And M-a-r-i-e?

The Witness: Yes, Your Honor.

Mr. Karzon: Mrs. Stuckey, by whom are you employed?

A. By the Internal Revenue Service.

Q. In what capacity are you employed by the IRS?

A. I'm an Internal Revenue Agent.

Q. How long have you been a Revenue Agent?

A. For seven years.

Q. Were you assigned to audit Record Wide Distributors for the taxable years 1972, 1973 and 1974?

A. I was assigned the audit of the 1972 Record Wide Distributors's tax return. And I picked up the subsequent years of 1973 and 1974, due to potential adjustments on the 1972 tax return.

Q. In the course of the audit, did you make any [184] adjustment to Record Wide's method of accounting?

A. Yes. I changed them from the cash method of accounting to the accrual method of accounting.

Q. Could you describe in greater detail, the adjustment that you made?

A. I increased their gross sales for each year, by the increase in accounts receivable, and made an appropriate increase or decrease to gross sales, based upon the increase or decrease in accounts payable.

Q. And why did you make these adjustments?

A. Because the taxpayer derived its gross sales from the sale of tapes and records, and they maintained an inventory as shown on their tax return. And the regulations require that whenever a taxpayer uses an inventory, to compute their gross sales — well, I'm sorry, to compute their gross profit, they must use the accrual method of accounting.

Q. Okay. You say that they used an inventory, do you have any information as to whether the inventory was an income producing factor for Record Wide?

A. The income was — the inventory was definitely an income producing factor, because the entire amount of gross sales was derived from the sale of the records and tapes, which comprised their inventory.

* * * * * * * *

[196] Stuckey - Cross

* * * * * * * *

Q. And what did you ask, and who did you ask?

A. I spoke with Mr. Randall Lytle, and I asked him for accounts receivable information. And then —

Q. Did you ask him —

A. May I continue, sir?

Q. Yes, you may.

A. And Mr. Lytle gave me the weekly accounts receivable balance sheets for the end of the year. When I reviewed them, I asked him to please explain to me, their policy on the credits, because the credits appeared very large. And this is when he explained to me, their policies on the credit returns, and I also had spoke with Mr. Keith Robley, regarding the refunds as shown on the 1972 return, and the returns and allowances as reflected on the 1973 and 1974 return.

Q. Were you advised that when they shipped merchandise to a customer, that customer had the right to return that merchandise ad infinitum, for credit against their account?

A. I was advised that they had a — they told me that they had a liberal return policy, and yes, that they had a lot of merchandise returned.

Q. Now then, you put them on accounts — you put them on accrual accounts receivable, why didn't you get into **[197]** accounts payable?

A. I took the accounts payable figure as listed on the tax return, Mr. Hanks. And I did allow them accounts payable for 1972. There were no accounts payable reflected for 1973 or 1974.

Q. Would you believe a company on December the 31st, would have paid, for every item they received during that year?

A. Yes, in this —

Q. You would believe that?

A. Yes, I would, in this case.

Q. Did Randall tell you he was on a strictly cash — that his suppliers all made him C.O.D.?

A. Would you repeat that, please?

Q. I said, did Mr. Lytle tell you that he was on a strict cash, C.O.D. basis with his suppliers?

A. No, sir, he did not.

Q. Well, then young lady, if he wasn't on a C.O.D. with his suppliers, unless he purchased nothing towards the end of the year, he would have had to have payables, isn't that correct?

A. Not if he had paid all the items that were due at the end of the year.

Q. Well, how come we came up with $96,000.00 in payables for the year 1972?

[198] A. Well, those items were not furnished to me during the audit. I allowed all the items that were furnished to me, Mr. Hanks.

Q. Young lady, these documents here, voluminous invoices were all provided for you at Record Wide Distributors, were they not?

A. I cannot say that every item in those boxes were furnished to me. At the time of the audit, there were two large boxes, not these specific boxes, but two boxes approximately this high, that had invoices all thrown in there, I don't know if there were accounts payable in there or not.

Q. How many years did you take for this audit?

A. Are you asking from the time I started the audit to the —

Q. Yes.

A. — time I submitted the case —

Q. Yes.

A. — unagreed?

Q. Uh-huh.

A. I began the audit in September of 1974, and I submitted the audit report, I believe it was in, either April or May of 1976.

Q. And we cooperated with you, did we not?

A. Yes, you did.

Q. I even flew to Nashville, Tennessee, to assist you [199] in getting any information you needed, did I not?

A. Yes, you did, Mr. Hanks.

Q. And Mr. Lytle cooperated with you, did he not?

A. Yes.

Q. And you were allowed to come out to the office in Record Wide Distributors, in Fenton, Missouri, and examine voluminous records, and documents, were you not?

A. Yes, I was. May I refer to one of the tax returns to answer one of your previous questions? I don't have them in front of me, but I would like to —

Q. What tax return do you want?

A. May I see the 1973 and the 1974 return, Mr. Hanks?

Q. Of Record Wide?

A. Yes, please. Okay, thank you.

Q. Now what question — wait until I get back up here to this thing. What question did you want to answer from those documents?

A. Well, I'd like to just backtrack on one question where you asked me why I did not go into accounts payable, and did I believe that taxpayer did, in fact, pay all their accounts at the end of the year. What led me to believe this for 1973 is that the taxpayer reflects a negative cash balance of $11,941.00 on their tax return, for the ending balance sheet dated December 31st, 1973. It was my understanding, during the audit, that they had written checks * * *.

* * * * * * *

Supreme Court, U.S.
FILED
JAN 3 1983
ALEXANDER L. STEVAS
CLERK

No. 82-868

In the Supreme Court of the United States

OCTOBER TERM, 1982

RECORD WIDE DISTRIBUTORS, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

REX E. LEE
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

TABLE OF AUTHORITIES

Cases:	Page
Brimberry v. *Commissioner*, 588 F.2d 975 .	4
Caldwell v. *Commissioner*, 202 F.2d 112 ..	4, 5
Commissioner v. *Hansen*, 360 U.S. 446 ...	3
Sika Chemical Corp. v. *Commissioner*, 64 T.C. 856, aff'd, 538 F.2d 320	4
Thor Power Tool Co. v. *Commissioner*, 439 U.S. 522	3, 4
Wilkinson-Beane, Inc. v. *Commissioner*, 420 F.2d 352	4
Statutes and regulation:	
Internal Revenue Code of 1954, 26 U.S.C. (& Supp. V) *et seq.*	
Section 446(b)	3
Section 166(a)(2)	4
26 C.F.R. 1.446–1(c)(2)(i)	3

In the Supreme Court of the United States

OCTOBER TERM, 1982

No. 82-868

RECORD WIDE DISTRIBUTORS, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The questions raised by the petition in this income tax case are whether the Commissioner correctly required petitioner to accrue as income amounts due for goods shipped on a "sale or return" basis, and whether the Commissioner correctly disallowed a bad debt deduction claimed by petitioner for a debt which it claimed was partially worthless.

The pertinent facts may be summarized as follows: Petitioner is a corporation engaged primarily in the wholesale distribution of record and tape "cut-outs," i.e., records and tapes which manufacturers have been unable to sell at full price through normal distribution channels (Pet. App. A-11). Petitioner purchases large quantities of these cut-outs, breaks them down into lots suitable for shipment to a retail store, and ships them to its customers for sale at greatly discounted prices (Pet. App. A-11). Because these cut-outs are often unmarketable, even at a discount, petitioner offers its

customers the privilege of returning all unsold merchandise for full credit on their accounts. It has been petitioner's policy to permit any customer with a good credit standing to defer payment on each lot of merchandise until he returned the unsold merchandise from that lot, together with payment for the items sold (Pet. App. A-11).

Although petitioner encourages its customers to account for each lot and return any unsold merchandise within 120 days after shipment, customers often take longer than 120 days after shipment. In some cases, petitioner's merchandise is not accounted for until more than a year after shipment (Pet. App. A-11). Approximately 30 to 35% of the merchandise shipped by petitioner each year is not accounted for (by return or payment) until a later taxable year (Pet. App. A-4). Under petitioner's so-called "hybrid" method of accounting, it expensed each lot of merchandise by removing it from inventory at the time the lot was shipped, but did not record the corresponding sales income until a later time when the customer paid for the items he had sold and returned any unsold merchandise for credit (Pet. App. A-12). Thus, petitioner treated such transactions as sales for expense purposes, but not for income purposes. Had petitioner wished to treat the transaction as a consignment rather than a sale, the proper accounting would have left the cutouts in inventory even though they had been shipped to a retailer on consignment.

During 1974, one of petitioner's major customers, Sound On Tape Distributors, Inc. was enjoined from selling certain tapes (App. A-17). This cast significant doubt on the collectibility of some $176,000 that Sound On Tape owed petitioner. Nonetheless, Sound On Tape continued in business until 1978 and petitioner continued to do business with it until then, when the debt was settled for $5,000 (Pet. App. 17-18).

1. The decision below correctly sustained the Commissioner's exercise of his statutory authority under Section 446(b) of the Internal Revenue Code of 1954 (26 U.S.C.) to require petitioner to use the accrual method for computing its taxable income from sales of merchandise. Treasury Regulations, Section 1.446-1(c)(2)(i) (26 C.F.R.) expressly requires a taxpayer using inventories to compute its income from purchases and sales on the accrual method unless the Commissioner authorizes the use of some other method. Here, it is undisputed that petitioner is required to use an inventory in the computation of its taxable income, and that its use of the so-called "hybrid" method of accounting on which its tax returns were prepared was never authorized by the Commissioner (Pet. App. A-12, A-13). Therefore, petitioner cannot use its hybrid method of accounting for tax purposes, and the Commissioner properly required it to change to an authorized, i.e., accrual, method for reporting its taxable income.

Petitioner errs in its assertion (Pet. 10) that it was entitled to select a method of accounting and that its choice was binding on the Commissioner as long as it used its method for keeping its books. As this Court has held, the Commissioner has broad statutory authority to determine whether a taxpayer's method of accounting clearly reflects its income and to require any changes which he finds necessary to assure and protect the equitable collection of the revenue. *Commissioner* v. *Hansen*, 360 U.S. 446, 467 (1959); *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 532, 542 (1979). In particular, petitioner may not, simply by adopting a method of accounting, limit the Commissioner's exercise of his discretion by requiring him to rebut a "presumption" in favor of the method chosen by the petitioner. *Thor Power Tool Co.* v. *Commissioner*, *supra*, 439 U.S. at 538-540. Thus, even on the assumption that petitioner had shown that its hybrid method of account-

ing conforms to generally accepted accounting principles (which it did not), such a showing would not have been sufficient to shift the burden to the Commissioner to show that it did not clearly reflect income before he could reject it for tax purposes. *Thor Power Tool Co.* v. *Commissioner*, *supra*, 439 U.S. at 538-544.

Wilkinson-Beane Inc. v. *Commissioner*, 420 F.2d 352, 355-356 (1st Cir. 1970), upon which petitioner relies (Pet. 6), does not conflict with the decision below. In that case, as here, the court of appeals affirmed the Tax Court's decision requiring a taxpayer using inventories to adopt an accrual method of accounting. Although the court in *Wilkinson-Beane, Inc.* noted in passing that the Tax Court had previously held that the cash method may clearly reflect income even though the taxpayer is required to use inventories in his business, the court held that, in order to prevail in such a case, the taxpayer must show that the results produced by his method of accounting are substantially identical to those reached by the Commissioner's method. *Id.* at 356. The hybrid method of accounting adopted by petitioner here clearly does not meet this standard (Pet. App. A-12).

2. Petitioner claims (Pet. 15-19) that it was entitled to deduct a portion of its receivable from Sound-On in 1974 as a partially worthless debt. A deduction for a partially worthless debt is allowable only when the Commissioner is satisfied that the debt is partially worthless. See Section 166(a)(2) of the 1954 code. Petitioner has failed to show that the Commissioner abused his discretion in disallowing the deduction in this case. *Brimberry* v. *Commissioner*, 588 F.2d 975, 977 (5th Cir. 1979); *Sika Chemical Corp.* v. *Commissioner*, 64 T.C. 856, 862-863 (1975), aff'd, 538 F.2d 320 (3d Cir. 1976).

Petitioner asserts (Pet. 17) that the decision below conflicts with *Caldwell* v. *Commissioner*, 202 F.2d

112, 115 (2d Cir. 1953). However, in *Caldwell* the issue was whether the Commissioner could require a taxpayer (1) to change from the cash to the accrual method of accounting and (2) to include in its income for the year of the change certain prior period receivables which would otherwise escape taxation. The court held that since the items in question did not represent income properly accruable in the taxable year of the change, they could not be rendered taxable merely because of the change in the taxpayer's method of reporting income.[1] *Id.* at 115-116. This case presents no such problems with respect to the effect of the change on the proper tax treatment of the Sound-On receivable. Here the court of appeals found that petitioner simply failed to carry its factual burden of establishing partial worthlessness of the debt (Pet. App. A-19). That factual question does not warrant further review.

CONCLUSION

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

JANUARY 1983

---

[1] The rule announced in *Caldwell* with respect to the omission of items of income resulting from a change in the taxpayer's method of accounting was legislatively overruled by the enactment of Section 481 as part of the Internal Revenue Code of 1954. For years after 1954, taxpayers are required to make appropriate adjustments in the year of a change in their method of accounting in order to prevent the duplication or omission of items solely because of the change.

Supreme Court, U.S.
FILED
JAN 20 1983
STEVAS
CLERK

No. 82-868

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

RECORD WIDE DISTRIBUTORS, INC.,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition For A Writ Of Certiorari To
The United States Court Of Appeals
For The Eighth Circuit

REPLY TO RESPONDENT'S MEMORANDUM IN OPPOSITION

CLAUDE HANKS, ESQ.
MB #16030
725 Old Ballas
Foreway Building
Creve Coeur, Missouri 63141
Tele: (314) 432-1170
Attorney for Petitioner

Of Counsel for Petitioner
LEONARD R. YOCUM, ESQ.
MB #15444
725 Old Ballas
Foreway Building
Creve Coeur, Missouri 63141
Tele: (314) 567-1424

St. Louis Law Printing Co., Inc., 411 No. Tenth Street 63101 314-231-4477

TABLE OF AUTHORITIES

Page

Cases

Calavo v. Commissioner, 304 F 2d 650 3,4

Caldwell v. Commissioner, 202 F 2d 112..... 4

Ezo Products Co., 37 T.C. 385 3

Glenn v. Kentucky Color and Chemical Co., Inc., 186 F 2d 975 3

Thor Power Tool Co. v. Commissioner, 439 US 522.... 3,4

Statutes and Regulations

IRC Section 446 (b) and (c)..... 5

Reg. 1-446-1 (b) 3,5

Reg. 1-446-1 (c) (2) (i) 3,5

No. 82-868

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

RECORD WIDE DISTRIBUTORS, INC.,
Petitioner

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition For A Writ Of Certiorari To
The United States Court Of Appeals
For The Eighth Circuit

REPLY TO RESPONDENT'S MEMORANDUM IN OPPOSITION

Petitioner points out that Respondent's statement of the facts, in part, is erroneous. Respondent has misstated one of the issues to be that the Commissioner correctly accrued income due for goods shipped on a "sale or return" basis (Resp.-1). The real issue in this Petition for Writ of Certiorari (other than the bad debt issue) is whether the Commissioner properly changed the Petitioner from a cash basis (hybrid) taxpayer to an accrual basis taxpayer without first finding that the taxpayer's hybrid method did not clearly reflect income. Further, in alleging facts, Respondent has indulged in argument on page 2 of his brief by concluding as a fact that Petitioner "expensed each lot of merchandise by removing it from inventory at the time the lot was shipped." There is no such evidence in the transcript of proceedings. Again, in the last sentence of the middle paragraph

on page 2, Respondent uses argument as a statement of fact when referring to consignment transactions. As a matter of fact, the inventory value was negligible compared to selling price, and if those cost values were omitted (and Petitioner does not admit that they were), a proper method of treatment would be to add those cost values to inventory to be in accord with Petitioner's hybrid method of accounting. However, the Commissioner never attacked Petitioner's treatment of such in the trial of the case in the Tax Court, nor did the auditing agent bother to do so. She relied on the proposition that Petitioner used inventories and, therefore, was required to use an accrual method of accounting. She did not bother to investigate the propriety of Petitioner's method to see if such method did or did not clearly reflect income.

Petitioner has never seen fit to argue that its method of operations had to be categorized as a "sale or return" or as a "consignment." These categorizations were first raised in the brief filed by Respondent in the Tax Court. No such issue was raised at audit time nor at trial in the Tax Court. It has been Petitioner's argument all along that these categorizations and their meaning have been developed in the field of commercial law in deciding issues of creditors' rights and do not apply to situations determinative of whether a taxpayer's accounting method clearly reflects income.

Respondent's argument in opposition (Resp.-3) cites 26 C.F.R.1. 446-1 (c) (2) (i) as justification for the Commissioner's action. As argued in our Petition for this Writ, that section of the regulations is subordinate to 446-1 (b), which requires the Commissioner to first find that Petitioner's method of accounting did not clearly reflect income. Respondent has based his whole case from the audit, through the Tax Court and through the Court of Appeals, on the singular proposition that Petitioner used inventories, therefore, Petitioner was mandated to use an accrual method of accounting.

We do not quarrel with Respondent's argument (Resp.-3) that the Commissioner has broad power to determine whether a taxpayer's method clearly reflects income. Respondent cites *Thor* in support of that proposition. However, in *Thor,* that taxpayer was already on the accrual method of accounting. The taxpayer had marked down its inventories in a manner contrary to the regulations and to standard accounting practice. *Thor* decided individual accounting transactions within the framework of a method of accounting that was, admittedly, an accrual method. Here, we have a hybrid method of accounting that has been changed to a strict accrual method by the Commissioner.

Respondent's argument at the bottom of page 3 and at the top of page 4 of his brief suggests that there is no burden at all on the Commissioner to first find that Petitioner's method did not clearly reflect income. As we interpret the regulations and the case law cited in our petition, the shifting of any bruden to the petitioner could only occur after the Commissioner had found that petitioner's accounting method did not clearly reflect income. *Reg. 1-446-1 (b). Glenn and Ezo, supra* (Petition-p.11). Here, as in the Tax Court and the Court of Appeals, Respondent has avoided the real issue in this case, which is the interpretations of Reg. 1-446-1 (b) and its conflict with Reg. 1-446-1 (c) (2) (i). Those subsections are not consistent with one another except as suggested by Petitioner that the latter refers to a voluntary change in accounting methods initiated by the taxpayer. (Petitioner's brief - page 14). If it does refer to voluntary changes by the taxpayer, then it is consistent with 1-446-1 (b). If it doesn't, there is no consistency in the two subsections, and this Court should resolve the inconsistency.

In reply to Point 2 of Respondent's argument that Petitioner has not shown that the Commissioner has abused his discretion in disallowing a deduction for the partial worthlessness of the Sound-On debt, we re-emphasize *Calavo, supra,* cited on page 17 of this Petition. *Calavo,* of course, was cited with approval in

Thor. Although the 9th Circuit in *Calavo* used the words "His discretion has thus been exercised under a misapprehension as to the circumstances affecting the Duarte account", there can be no argument but that the Commissioner was being politely told that he abused his discretion. The 9th Circuit then told the Commissioner to go back and re-exercise his discretion upon the question of the Duarte account. As in *Calavo* (at 655), the Commissioner has, in disallowing any addition to a reserve for bad debts, refused to give any consideration whatsoever to the circumstances affecting the Sound-On account. He has disregarded the severe financial setback that occurred to Sound-On in 1974. By ignoring that substantial debt, and placing Petitioner on an accrual method of accounting, he has, in effect, increased Petitioner's income in 1974 by approximately $176,000.00, and has not allowed even $1.00 as a bad debt offset to this increase. What else does Petitioner or any other taxpayer have to do to prove an abuse of discretion?

The last part of Respondent's argument refers to *Caldwell, supra,* cited by Petitioner. Respondent has ignored that part of Petitioner's argument on the standard accounting practice of a reasonable allowance for a deduction for a bad debt reserve for the debt of Sound-On. For some reason, the Respondent refers to the fact that the court in *Caldwell* would not include as income, in the tax year in question, those parts of accounts receivable that represented sales in a prior tax year. That part of *Caldwell* has nothing to do with the fact situation in our case. Our reference in our argument was to that part of the opinion (at page 116 - headnote 8) relating to the bad debt issue decided in *Caldwell.* The only reference Respondent has raised in opposition to our Petition is his footnote 1, in which he abstractly suggests that *Caldwell* has been "legislatively overruled" by the enactment of IRC Section 481. Section 481 is a lengthy provision of the code including many paragraphs and subparagraphs. Petitioner can find no specific relevance to any part of the bad debt issue before this court. In reality, Petitioner's argument is based upon equity and fair play. The *Caldwell* decision does nothing more than emphasize those principles of equity and fair play.

CONCLUSION

Respondent's reply in opposition offers nothing in opposition to the issues presented by Petitioner's application for a Writ of Certiorari. Respondents have not addressed the issues presented. This Court should hear this Petition and decide that sub-paragraphs (b) and (c) of IRC Section 446, and the regulations thereunder, are inconsistent with each other and that Section 1-446-1 (c) (2) (i) is subordinate to the provisions of Section 1-446-1 (b). In the alternative, the decision of the Eighth Circuit Court of Appeals, on the bad debt issue, conflicts with the decisions of the Second and Ninth Circuits in this regard, and the Writ should issue for these reasons.

Respectfully submitted,

CLAUDE HANKS, ESQ. MB#16030
725 Old Ballas, Foreway Bldg.
Creve Coeur, MO 63141
Telephone: (314) 432-1170
Attorney for Petitioner

Of Counsel for Petitioner
LEONARD R. YOCUM, ESQ. MB#15444
725 Old Ballas, Foreway Bldg.
Creve Coeur, MO 63141
Telephone: (314) 432-1170

CERTIFICATE OF SERVICE

I do hereby certify that three true and correct copies of the foregoing were mailed, postage prepaid, to: Mr. John F. Murray, Acting Assistant Attorney General, Tax Division, United States Department of Justice, Washington, D.C. 20520; and Mr. Jerome D. Sebastian, acting Chief Counsel, Internal Revenue Service, Washington, D.C. 20530; and The Honorable Rex E. Lee, Solicitor General of the United States, Washington, D.C. 20530; by placing same in envelopes so addressed and depositing same in U.S. First Class mail, on this 20th day of January, 1983.

CLAUDE HANKS